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U.S. Dept. of the Treasury.
Title:
The taxation of farmer's cooperative associations
Place:
Washington
Date:
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U. S. Treasury dept. Division of tax research.
The taxation of farmers' cooperative associations. 1947.
~~2~~ 3, vii, 60 p.

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TAXATION OF FARMER'S COOPERATIVE

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FOR RELEASE, AFTERNOON NEWSPAPERS,
Friday, October 31, 1947.

Press Service
No. S-520

The Treasury Department today made public a study entitled "The Taxation of Farmers' Cooperative Associations", prepared by its Division of Tax Research as one of a series in connection with the Treasury's work on postwar tax revision. The study analyzes the present tax treatment of farm cooperatives and the chief suggestions that have been made for changes in this treatment. It makes no policy recommendations.

While farm cooperatives are only one of numerous cooperative groups, the study observes that they are the most important group and that the issues and problems relating to their taxation are fundamentally the same as for the others.

Through statutory exemption more than half of the farm cooperatives are completely exempt from the income tax, and the exclusion of "patronage dividends" from taxable income results in the remaining farm cooperatives being taxed on only a small part of the net proceeds of their operations. These facts have given rise to charges that the farm cooperative associations enjoy unjustifiable tax advantages over their competitors.

Most of the earnings of the farm cooperatives, however, including cooperatives which are tax exempt by statute, are taxable to patrons and members as individuals. Recipients of limited dividends on the capital stock of cooperatives must account for the dividends as individual income. Patronage dividends paid or credited to patrons constitute an increase in farm receipts or a decrease in farm costs, and thus figure in the taxable income of individual farmers.

Out of this situation arises the basic question whether cooperatives as such should be taxed in a manner more nearly comparable with the taxation of ordinary corporations, or whether economic income earned by the cooperatives should be taxed mainly or exclusively at the individual level, as in the case of unincorporated businesses.

A principal difference between the farm cooperative and the ordinary business corporation lies in the fact that net proceeds of the cooperative, after provision for limited dividends on stock and for necessary reserves, are returnable, not to stockholders in proportion to stock owned, but to members of the cooperative in proportion to the use made of the cooperative's services by each. The amounts so returned to patrons are called patronage dividends.

Full statutory exemption of more than half the farm cooperatives dates back to laws of 1916 and 1921. Eligibility for full exemption is limited to cooperatives which are under obligation to return all net proceeds to patrons without discrimination between members and non members. There are certain other requirements.

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There is no express statutory provision for excluding the amounts of patronage dividends from the taxable income of cooperatives, but this exclusion has long been allowed under Treasury rulings and court decisions.

If the exemption statutes were repealed, cooperatives now exempt from all income taxes would become subject to tax on income used to pay dividends on capital stock, on amounts retained in certain reserves, and on their non-operating income. Amounts thus subjected to tax would be relatively small, however, so long as patronage dividends remained excludable. Moreover, exemption repeal would mean that the cooperatives would no longer be subject to present limitations on their dealings with non-farmers and so would be free to extend their activities in urban areas.

Benefits to the cooperatives from exclusion of patronage dividends from taxable income depend on the nature of these payments. Determining the nature of the payments is difficult or impossible, and hence appraising the benefits of exclusion is hard. Insofar as the dividends represent the owner-patron's share in the cooperative's economic income, the cooperative escapes the so-called double taxation imposed on the distributed income of ordinary corporations. But when the payments represent a return of capital, or price adjustments, no special tax advantage accrues.

In connection with the charge that tax privileges of farm cooperatives have given them an advantage over competitors, the Treasury study states that the dollar volume of business done by the cooperatives has increased more than two and a half times since 1939. However, it appears that the business of the cooperatives has not increased faster than that of other types of firms doing business with farmers. There has been an increase in manufacturing by the cooperatives, but such manufacturing is of little significance, in the aggregate.

As changes which have been suggested in the tax treatment of farm cooperatives, the study lists: (1) Repeal of the exemption; (2) inclusion of all patronage dividend amounts in the taxable income; (3) inclusion of patronage dividends paid in non-cash form, while continuing the exclusion of cash dividends; (4) imposition of a gross receipts tax or a tax on invested capital, in lieu of income tax.

The study discusses all of these suggestions and presents data bearing on them.

So long as patronage dividends continue to be excluded from the taxable income of cooperatives, loss of full exemption would impose relatively little tax on cooperatives now exempt.

For a variety of reasons the economic income produced by cooperatives cannot be accurately measured by the amount of patronage dividends distributed, and the appropriateness of using these dividends as a base for assessment of income tax on the cooperatives has been questioned.

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The success of a cooperative is not measured in terms of its own income, or of the size of its patronage dividends. Inclusion of these dividends in the taxable income of the cooperatives might merely induce more of them to set their prices so as to minimize the amount of patronage dividends.

If non-cash patronage dividends were included in the taxable income of cooperatives, while cash patronage dividends continued to be excluded, it appears that most cooperatives would still be able to build up substantial amounts of capital out of earnings not taxed to them, by levying assessments against members and by similar devices.

The idea of a tax on gross receipts or sales of farm cooperatives, or on invested capital, as an alternative to the income tax method meets the obstacle that it would be very difficult if not impossible to devise rates which would be equivalent to the income taxation of ordinary corporations.

One of the statistical tables in the study places the number of farmers' marketing and purchasing cooperative associations in the United States at 10,150 as of the 1944-45 marketing season. They had an estimated membership of 4,506,000 and an estimated business of $5,645,000,000.

About 94 percent of these cooperatives are local associations operating in a relatively small area. A substantial proportion of the total volume of marketing and purchasing done by farm cooperatives is, however, accounted for by large-scale centralized or federalized associations doing business over larger areas.

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THE TAXATION OF FARMERS' COOPERATIVE ASSOCIATIONS

Division of Tax Research, Treasury Department
October 1947

The Taxation of Farmers' Cooperative Associations

The controversial question of the taxation of farmers' cooperative associations is only one aspect of the broader problem of taxation of various forms of business enterprise. The basic issue is whether the cooperative associations as such should pay such taxes as would make their treatment more nearly comparable with that of ordinary corporations or whether economic income earned by the cooperatives should be taxed mainly or exclusively at the individual level, as is the case with unincorporated businesses.

Farmers' marketing and purchasing associations are only one of a number of groups of cooperative associations that share their benefits primarily among patrons on the basis of use made of the organization rather than among investors on the basis of capital supplied. The farm cooperatives, however, are the most important of these groups, and the issues and problems relating to their taxation are fundamentally the same as for the other cooperatives.

This report analyzes the present tax treatment of farm cooperatives and the chief suggestions that have been made for revision. The report makes no policy recommendations, but it presents considerations relevant to an appraisal of the various methods of taxation.

The study was prepared in the Business Tax Section of the Division of Tax Research. In its preparation valuable assistance and suggestions were received from other members of the Treasury tax staff, including consultation with members of the Office of Tax Legislative Counsel on legal matters and of the Bureau of Internal Revenue on administrative matters.

In the preparation of this study, extensive use was made of basic data and technical information made available by the Cooperative Research and Service Division of the Farm Credit Administration, Department of Agriculture. The report, however, is not to be construed as necessarily reflecting in any way the views of the Farm Credit Administration.

This subject has been under consideration by a committee composed of the technical tax staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation. An earlier draft of this study was made available to the committee, and the study has benefited at various points by the committee's discussions. The material contained herein, however, is not to be considered as necessarily representing in any way the views of the staff of the Joint Committee on Internal Revenue Taxation.

Division of Tax Research
U.S. Treasury Department

October 1947

The Taxation of Farmers' Cooperative Associations

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The Taxation of Farmers' Cooperative Associations

SUMMARY

I. Introduction

Farmers' cooperative associations, it has been charged, are now enjoying unjustifiable tax advantages over their competitors. The relatively small amount of income tax paid by these cooperatives, which is the basis of this complaint, is attributable to (1) the statutory exemption from income tax of certain of the associations and (2) the exclusion from their taxable income, under Treasury rulings and court decisions, of patronage dividends paid by other cooperatives. As a result of the exemption, more than one-half of farm cooperatives are completely exempt from the income tax. As a result of the exclusion of patronage dividends, the remaining farm cooperatives are subject to tax on only a small part of the net proceeds of their operations.

Although farm cooperative associations themselves pay relatively little income tax, most of the income earned, even by tax-exempt cooperatives, should affect the tax liabilities of patrons and members. The limited dividends on capital stock of cooperatives are taxable income to recipients. Patronage dividends paid or credited to patrons constitute an increase in farm receipts or a decrease in farm costs and thus should enter into the taxable income of individual farmers. The tax treatment of exempt farm cooperatives is therefore in principle similar to the treatment of partnerships and proprietorships, which pay no tax as such but whose participants are taxed on the income they derive from the business. The exception to this analogy is the treatment of certain reserves set up out of earnings by exempt cooperatives, which are subject to tax to neither the association nor its members. In the case of taxable cooperatives, income used to pay dividends on capital stock and as reserves is taxed to the association under the corporation income tax.

In the present controversy over the taxation of farm cooperatives, the basic questions at issue are whether the income earned by the cooperatives should be taxed more heavily to the associations as distinguished from their members and, if so, how this can best be accomplished.

The purpose of this report is to discuss the considerations relevant to an appraisal of the present and alternative methods of taxing farm cooperatives.

II. Purpose, structure, and importance of farmers' cooperative associations

Cooperative associations today engage in a wide variety of business activities, the primary purpose of which is to increase the income which their farmer members derive from farming. The principal difference between the farm cooperative and the ordinary business corporation lies in the fact that all net proceeds remaining after provision for limited dividends on stock and for necessary reserves are returnable, not to stockholders in proportion to stock owned, but to the members of the cooperative in proportion to the use made of the association by each. The amounts so returned to patrons are usually called "patronage dividends" or "patronage refunds".

At the present time, there are about 10,150 farmers' marketing and purchasing associations active in the United States. For the marketing season 1944-45, they reported an aggregate volume of business of $5.645 million. About 94 percent of these cooperatives are local associations whose operations are confined to a relatively small area. A substantial proportion of the total volume of marketing and purchasing done by farm cooperatives is, however, accounted for by large-scale centralized or federated cooperative associations which operate over larger areas. Some of these large-scale cooperatives also engage in the processing of farm products and in the manufacturing of farm supplies, but the non-trading activities of farm cooperatives are economically significant only in a very few lines.

The individual farmer shares in the benefits of the cooperative mainly as a patron; but, as a supplier of capital, he receives a limited return on his equity in the association. As a patron, the farmer's share in the success of the cooperative takes the form of patronage dividends or higher prices for the products he sells or lower prices for the products he buys.

The extent of use of patronage dividends as distinguished from direct price adjustments varies widely among cooperatives. Some associations attempt to pay patronage dividends reflecting their actual trading margins, but others do not use patronage dividends at all or pay amounts that may either overstate or understate their trading margins. From a statistical study made in 1936, it appears that out of the 10,752 farm marketing and purchasing associations active at that time, only 32 percent of the former and 54 percent of the latter reported payment of patronage dividends.

Farm cooperatives do not distribute all of their patronage dividends in cash form. They often retain a part of their net proceeds for use as working or fixed capital and distribute patronage dividends in the form of stock, certificates of equity, certificates of indebtedness, or book credits. Furthermore, to a limited extent, cooperatives

may secure capital funds by setting up certain reserves out of earnings before computing the amount to be returned to patrons. Finally, capital may be secured by direct assessments on members levied in proportion to the use made of the association.

III. Present tax treatment of farm cooperatives under the Federal income tax

A. Background of the present treatment

The present tax treatment of farm cooperatives has been in effect since the early years of the Federal income tax. Express statutory exemption from income tax was granted, under certain conditions, to marketing associations in 1916 and to purchasing associations in 1921. Although there is no express statutory provision for the exclusion of patronage dividends from the income of the cooperatives, the Treasury and the courts have interpreted the law as permitting cooperatives to exclude (or deduct) from their taxable income patronage dividends or refunds paid in accordance with a contractual or other definite obligation.

B. Tax exemption

Eligibility for income-tax exemption has always been limited to associations under obligation to return all net proceeds to patrons without discrimination between members and non-members. In the case of exempt marketing cooperatives, all of the business must arise from producers, and in the case of exempt purchasing associations, not more than 15 percent of total business may be done for those who are neither producers nor members. Exempt cooperatives must also limit their dividends on capital stock. They are not prevented from engaging in manufacturing or processing where such activities are necessary to the efficient discharge of their basic functions.

Although the tax advantages attributable to the exemption as such are relatively small, exempt cooperatives would lose certain benefits if the exemption were repealed but the exclusion of patronage dividends continued. Associations now exempt from all income taxes would become subject to tax on income used to pay dividends on capital stock, on amounts retained in certain reserves, and on their non-operating income. On the other hand, these cooperatives would no longer be subject to the present limitations on their dealings with non-farmers and so would be free to extend their activities in urban areas.

C. Patronage-dividend exclusion

Exclusion of patronage dividends or refunds from taxable income is not limited to cooperatives. In the case of both cooperatives and ordinary corporations, patronage dividends or price rebates are excludable if paid in accordance with a contractual obligation in effect at the time of the transaction. There is, of course, this basic difference: member-patrons receiving refunds from cooperatives, unlike patrons of ordinary businesses, are also the owners of the enterprise. If, however, members of the cooperative alone are eligible to receive patronage dividends, dividends representing profits from transactions with non-members are not excludable. For purposes of the exclusion, non-cash forms of payment are regarded as the equivalent of cash distributions.

The benefits that farm cooperatives derive from the exclusion of patronage dividends from their taxable incomes depend on the nature of these payments. To the extent that patronage dividends represent the owner-patron's share in the association's net operating margin, the exclusion gives cooperatives the advantages of the partnership treatment by freeing them of the so-called double taxation imposed on the distributed income of ordinary corporations. To the extent, however, that patronage dividends represent non-income elements--items analogous to selling expenses of ordinary businesses or evidences of capital contributions of patrons--their exclusion from taxable income of the cooperatives confers no special tax advantage. Since it is difficult or impossible to separate patronage dividends into their components, it is extremely hard to appraise the benefits of the exclusion.

D. Effect of present tax treatment on competitive position of farm cooperatives

It has been charged that the complete or virtual tax immunity of farm cooperatives from income tax has given these associations an advantage over their competitors. It is true that the dollar volume of business done by farm cooperatives has increased more than two and one-half times since 1939, but the increases in cooperative marketing and purchasing are no greater in the aggregate than the increases in total cash receipts from farm marketing and purchasing. There is no evidence that the associations as a whole have enlarged their relative share of the total market in recent years. There has been an increase in manufacturing by cooperatives, but in the aggregate this type of activity is of little significance.

IV. Considerations relating to proposed changes in the present tax treatment of farm cooperatives

A. Changes proposed in the present treatment

Among the suggestions that have been made for revising the present tax treatment of farm cooperatives are: (1) repeal of the exemption; (2) inclusion of all patronage dividends in the taxable income of farm

cooperatives; (3) inclusion of patronage dividends paid in non-cash form in the taxable income of farm cooperatives, while continuing the exclusion of cash patronage dividends; and (4) imposition of a gross-receipts tax or a tax on invested capital, in lieu of income tax on farm cooperatives.

B. Repeal of the exemption

The exemption of eligible farm cooperatives from income tax has been defended on the grounds that these associations (1) operate in the public interest, (2) are not themselves profit-making institutions, and (3) are more nearly analogous to partnerships than to ordinary corporations. Those who urge repeal of the exemption argue that the cooperatives closely resemble ordinary corporations in economic functions, organization, and operations, and hence should be taxed like ordinary corporations.

In appraising the arguments for and against the exemption, it may be recognized that there is always a presumption against any tax exemption. This presumption can be overcome only by a convincing demonstration that the exemption is in the public interest.

So long as patronage dividends continue to be excluded from the gross income of cooperatives, loss of the exemption would impose relatively little tax on cooperatives now exempt.

Short of full repeal, it has been suggested that the exemption should be confined to small local cooperatives. This, however, would raise a difficult problem of fairly determining eligibility for the exemption. It has been suggested that, if the exemption is retained, certain ambiguities in the present law, such as those relating to the treatment of income from manufacturing operations or from by-products, should be cleared up.

C. Require the inclusion of all patronage dividends in the income of cooperatives

The exclusion of patronage dividends from the gross income of cooperatives has been defended on the grounds that (1) patronage dividends are price rebates and as such are not income of the association within the meaning of the Sixteenth Amendment, (2) the cooperatives are acting merely as agents of patrons and have no interest in the net proceeds of their operations, and (3) even if patronage dividends could be constitutionally taxed to the cooperatives, they should not be so taxed because it is impossible to determine to what extent they represent distributions of income and to what extent they do not. Those who favor the inclusion of patronage dividends in the gross income of cooperatives deny each of these contentions.

INTENTIONAL SECOND EXPOSURE

C. Patronage-dividend exclusion

Exclusion of patronage dividends or refunds from taxable income is not limited to cooperatives. In the case of both cooperatives and ordinary corporations, patronage dividends or price rebates are excludable if paid in accordance with a contractual obligation in effect at the time of the transaction. There is, of course, this basic difference: member-patrons receiving refunds from cooperatives, unlike patrons of ordinary businesses, are also the owners of the enterprise. If, however, members of the cooperative alone are eligible to receive patronage dividends, dividends representing profits from transactions with non-members are not excludable. For purposes of the exclusion, non-cash forms of payment are regarded as the equivalent of cash distributions.

The benefits that farm cooperatives derive from the exclusion of patronage dividends from their taxable incomes depend on the nature of these payments. To the extent that patronage dividends represent the owner-patron's share in the association's net operating margin, the exclusion gives cooperatives the advantages of the partnership treatment by freeing them of the so-called double taxation imposed on the distributed income of ordinary corporations. To the extent, however, that patronage dividends represent non-income elements—items analogous to selling expenses of ordinary businesses or evidences of capital contributions of patrons—their exclusion from taxable income of the cooperatives confers no special tax advantage. Since it is difficult or impossible to separate patronage dividends into their components, it is extremely hard to appraise the benefits of the exclusion.

D. Effect of present tax treatment on competitive position of farm cooperatives

It has been charged that the complete or virtual tax immunity of farm cooperatives from income tax has given these associations an advantage over their competitors. It is true that the dollar volume of business done by farm cooperatives has increased more than two and one-half times since 1939, but the increases in cooperative marketing and purchasing are no greater in the aggregate than the increases in total cash receipts from farm marketing and purchasing. There is no evidence that the associations as a whole have enlarged their relative share of the total market in recent years. There has been an increase in manufacturing by cooperatives, but in the aggregate this type of activity is of little significance.

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A. Changes proposed in the present treatment

Among the suggestions that have been made for revising the present tax treatment of farm cooperatives are: (1) repeal of the exemption; (2) inclusion of all patronage dividends in the taxable income of farm

cooperatives; (3) inclusion of patronage dividends paid in non-cash form in the taxable income of farm cooperatives, while continuing the exclusion of cash patronage dividends; and (4) imposition of a gross-receipts tax or a tax on invested capital, in lieu of income tax on farm cooperatives.

B. Repeal of the exemption

The exemption of eligible farm cooperatives from income tax has been defended on the grounds that these associations (1) operate in the public interest, (2) are not themselves profit-making institutions, and (3) are more nearly analogous to partnerships than to ordinary corporations. Those who urge repeal of the exemption argue that the cooperatives closely resemble ordinary corporations in economic functions, organization, and operations, and hence should be taxed like ordinary corporations.

In appraising the arguments for and against the exemption, it may be recognized that there is always a presumption against any tax exemption. This presumption can be overcome only by a convincing demonstration that the exemption is in the public interest.

So long as patronage dividends continue to be excluded from the gross income of cooperatives, loss of the exemption would impose relatively little tax on cooperatives now exempt.

Short of full repeal, it has been suggested that the exemption should be confined to small local cooperatives. This, however, would raise a difficult problem of fairly determining eligibility for the exemption. It has been suggested that, if the exemption is retained, certain ambiguities in the present law, such as those relating to the treatment of income from manufacturing operations or from by-products, should be cleared up.

C. Require the inclusion of all patronage dividends in the income of cooperatives

The exclusion of patronage dividends from the gross income of cooperatives has been defended on the grounds that (1) patronage dividends are price rebates and as such are not income of the association within the meaning of the Sixteenth Amendment, (2) the cooperatives are acting merely as agents of patrons and have no interest in the net proceeds of their operations, and (3) even if patronage dividends could be constitutionally taxed to the cooperatives, they should not be so taxed because it is impossible to determine to what extent they represent distributions of income and to what extent they do not. Those who favor the inclusion of patronage dividends in the gross income of cooperatives deny each of these contentions.

Court decisions have been cited by those who take positions on either side of the constitutional issue as to whether patronage dividends can be regarded as a part of the income of the cooperatives. The issue, however, is not likely to be finally decided unless Congress specifically presents it to the courts by discontinuing the exclusion.

A successfully operated farm cooperative will ordinarily produce some economic income over a period of years, especially if it uses any significant amount of capital and assumes any significant degree of risk. It does not, of course, necessarily follow that this economic income should be taxed to the cooperative, as distinguished from its patrons and members. There are numerous instances where the incomes of certain types of business organizations are not taxed to the business entity as such.

The economic income produced by cooperatives, moreover, cannot be accurately measured by the amount of patronage dividends distributed. Many cooperatives so conduct their business that no patronage dividends are needed to return benefits to patrons. In other cases, patronage dividends overstate the income earned by cooperatives because they merely take the place of special services, such as free delivery and credit, which would give rise to allowable cost-deductions in the case of ordinary businesses. In still other cases, marketing cooperatives deliberately set prices paid below the market, or purchasing cooperatives set prices charged above the market, in order to accumulate capital. In these cases, patronage dividends are paid in non-cash form as evidence of patrons' capital contributions and do not represent solely the economic income produced by the cooperative. For these and other reasons, the appropriateness of patronage dividends as a base for assessment of income tax on cooperatives has been questioned.

Moreover, the success of the cooperative association is not measured in terms of its own income, or of the size of its patronage dividends. Therefore, the inclusion of patronage dividends in the gross income of the cooperatives might merely induce more of the associations to set their prices so as to minimize their patronage dividends. Methods of preventing this have been suggested, but it does not appear likely that they could produce satisfactory results.

D. Continue the exclusion of cash patronage dividends but require the inclusion of non-cash patronage dividends in the income of cooperatives

A special case has been advanced for the inclusion of non-cash patronage dividends in the income of cooperatives, while continuing the exclusion of cash patronage dividends. Those who favor this approach argue that most patrons have little real choice as to the form in which they receive their patronage dividends, and that non-cash patronage dividends cannot be readily converted into cash. They conclude that these payments therefore cannot be regarded as true

rebates but should be considered a part of the income of the cooperative. Dissenters from this conclusion emphasize that membership in a cooperative is voluntary and that members actively participate in decisions with respect to payment of patronage dividends.

If non-cash patronage dividends were included in the taxable income of cooperatives, while cash patronage dividends were excluded, it appears that most of the associations would still be able to build up substantial amounts of capital out of earnings not taxed to the association. This could be done by such devices as giving patrons the option to receive cash or stock, which would probably be held by the courts to be equivalent to a cash distribution and hence excludable. It would also be possible for many cooperatives to make wider use of direct assessments on patrons in proportion to cash patronage dividends received.

E. Alternatives to the income tax a method of taxing farm cooperatives

The difficulties that would be encountered in attempting to include patronage dividends in the taxable income of farm cooperatives have persuaded some critics of the present treatment that an alternative tax should be imposed on cooperatives in lieu of the income tax.

1. Gross receipts tax

One such alternative would be a tax based on gross receipts or sales. It would, however, be impossible to select any one rate of tax on gross sales which would be approximately equivalent to a corporate income tax on the economic income earned by cooperatives. The amount of net income earned on a dollar of gross sales varies widely among manufacturers, wholesalers, and retailers in different lines and among firms in the same line. Attempts to select different rates for different types of cooperatives would result in great difficulties and would still leave the equity problem unsolved in borderline cases. Moreover, it is generally agreed that a gross receipts tax is more likely to be passed on to consumers than is a net income tax, and, at least in the case of large marketing associations, the tax might therefore fail to achieve its objective.

2. Tax on invested capital

Another alternative tax that has been suggested is one based on invested capital. As in the case of a gross receipts tax, the selection of a rate that would approximate a tax on net income would be difficult, if not impossible. Moreover, a tax on invested capital would bear more heavily on weak cooperatives than on strong and successful associations. Such a tax would give rise to serious administrative and legal problems in connection with the definition and valuation of invested capital.

INTENTIONAL SECOND EXPOSURE

Court decisions have been cited by those who take positions on either side of the constitutional issue as to whether patronage dividends can be regarded as a part of the income of the cooperatives. The issue, however, is not likely to be finally decided unless Congress specifically presents it to the courts by discontinuing the exclusion.

A successfully operated farm cooperative will ordinarily produce some economic income over a period of years, especially if it uses any significant amount of capital and assumes any significant degree of risk. It does not, of course, necessarily follow that this economic income should be taxed to the cooperative, as distinguished from its patrons and members. There are numerous instances where the incomes of certain types of business organizations are not taxed to the business entity as such.

The economic income produced by cooperatives, moreover, cannot be accurately measured by the amount of patronage dividends distributed. Many cooperatives so conduct their business that no patronage dividends are needed to return benefits to patrons. In other cases, patronage dividends overstate the income earned by cooperatives because they merely take the place of special services, such as free delivery and credit, which would give rise to allowable cost-deductions in the case of ordinary businesses. In still other cases, marketing cooperatives deliberately set prices paid below the market, or purchasing cooperatives set prices charged above the market, in order to accumulate capital. In these cases, patronage dividends are paid in non-cash form as evidence of patrons' capital contributions and do not represent solely the economic income produced by the cooperative. For these and other reasons, the appropriateness of patronage dividends as a base for assessment of income tax on cooperatives has been questioned.

Moreover, the success of the cooperative association is not measured in terms of its own income, or of the size of its patronage dividends. Therefore, the inclusion of patronage dividends in the gross income of the cooperatives might merely induce more of the associations to set their prices so as to minimize their patronage dividends. Methods of preventing this have been suggested, but it does not appear likely that they could produce satisfactory results.

D. Continue the exclusion of cash patronage dividends but require the inclusion of non-cash patronage dividends in the income of cooperatives

A special case has been advanced for the inclusion of non-cash patronage dividends in the income of cooperatives, while continuing the exclusion of cash patronage dividends. Those who favor this approach argue that most patrons have little real choice as to the form in which they receive their patronage dividends, and that non-cash patronage dividends cannot be readily converted into cash. They conclude that these payments therefore cannot be regarded as true

rebates but should be considered a part of the income of the cooperative. Dissenters from this conclusion emphasize that membership in a cooperative is voluntary and that members actively participate in decisions with respect to payment of patronage dividends.

If non-cash patronage dividends were included in the taxable income of cooperatives, while cash patronage dividends were excluded, it appears that most of the associations would still be able to build up substantial amounts of capital out of earnings not taxed to the association. This could be done by such devices as giving patrons the option to receive cash or stock, which would probably be held by the courts to be equivalent to a cash distribution and hence excludable. It would also be possible for many cooperatives to make wider use of direct assessments on patrons in proportion to cash patronage dividends received.

E. Alternatives to the income tax a method of taxing farm cooperatives

The difficulties that would be encountered in attempting to include patronage dividends in the taxable income of farm cooperatives have persuaded some critics of the present treatment that an alternative tax should be imposed on cooperatives in lieu of the income tax.

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The Taxation of Farmers' Cooperative Associations

I. Introduction

The taxation of farmers' cooperative associations is a highly controversial issue of postwar taxation. Existing law exempts more than one-half of farmers' cooperative associations from the income tax altogether. Under rulings of the Bureau of Internal Revenue and court decisions the remaining associations are allowed to exclude so-called patronage refunds or dividends from their taxable income. Since cooperatives are required by their charters or by-laws to distribute to their members on the basis of patronage all of their net proceeds after provision for limited dividends on capital stock and for necessary reserves, the amount of taxable income reported by non-exempt associations is ordinarily very small. Patronage dividends, whether paid in cash or non-cash form, are includible, however, in the taxable income of the individual farmer-patron.

Farmers' cooperative marketing and purchasing associations are only one group of a wide variety of voluntary business associations whose benefits are shared among participants in proportion to each individual's use of the organization rather than in proportion to equity capital supplied. The tax treatment of all of these associations raises controversial issues. This report, however, is primarily concerned with the problems and considerations raised by the farmers' cooperatives. Farmers' cooperatives are of much greater economic importance than the other groups, and the tax controversy has centered almost entirely on them. Moreover, most of the essential economic, legal, and administrative issues raised apply equally to all cooperative associations. 1/

Although farmers' cooperative associations have long been favorably regarded because of their contributions to the economic well-being of the American farmer, the disparity between their Federal income tax payments and those of ordinary business corporations has occasioned much criticism. In the prewar years of relatively low corporate tax rates, few questioned the treatment accorded farm cooperatives under the income tax law and regulations. With the wartime increases in corporate tax rates, however, complaints became more widespread. At a time when ordinary trading corporations with gross sales of $59 billion were paying Federal income taxes of nearly $2 billion, 2/ farm cooperatives with $5 billion of sales are estimated to have been paying no more than $10-$20 million of Federal income taxes. This sharp difference in tax

1/ The economic importance and the present tax treatment of the types of cooperatives not specifically discussed in the body of this report are outlined in Appendix A.

2/ Preliminary statistics for corporation income and declared-value excess-profits tax returns for 1944. Treasury Press Service, No. S-275.

liabilities, it has been charged, violates the principle that persons and firms in substantially similar circumstances should pay substantially the same taxes and also gives the cooperative associations an unjustifiable competitive advantage over ordinary corporations. Moreover, the virtual freedom of farm cooperatives from Federal income taxes is said to deprive the Government of much-needed revenue.

Although the exemption of certain farm cooperatives from the income tax and the exclusion of patronage dividends from the taxable income of non-exempt farm cooperatives are said to give these organizations a substantial tax advantage over ordinary corporations, the tax treatment accorded them is essentially similar to that applied to partnerships and sole proprietorships. Under the present Federal tax law, unincorporated businesses are not taxed as such. Instead, all of the income arising from such businesses is taxed in the hands of the individual proprietor or partners. Proprietorship and partnership profits are not, therefore, tax free although they are not subject to the so-called double taxation imposed on distributed corporate profits. Similarly, cooperative profits, even when earned by exempt associations, are not tax free except to the extent they are retained in certain reserves. When earned by non-exempt associations, cooperative earnings are in no case tax free. Patronage dividends of marketing associations should enter directly into the income of patrons as receipts from sale of farm produce, and patronage dividends of purchasing associations should enter indirectly into the income of patrons as a reduction in the cost of production of farm products sold by the patrons. 1/

Thus profits of cooperatives, although lightly taxed or completely exempt in the hands of the associations, are, in the main, taxed like other income in the hands of the stockholders and patrons. The question at issue is, therefore, not whether the profits of cooperatives should be taxed or not taxed, but whether the income earned by these organizations should be more heavily taxed before it is distributed to the individual owners of the business.

Those who hold that cooperative associations as such should pay heavier taxes suggest various revisions. Some would be content merely to repeal the exemption; others would not be satisfied unless in addition patronage dividends were included in the gross income of the cooperative associations. Still others, impressed with the difficulties of taxing cooperative associations fairly under the corporation income tax, would instead subject them to a special tax based on some other measure of their ability to pay.

Another approach to equalizing taxes on cooperatives and ordinary corporations would be to give all corporations a deduction for dividends paid. Although this proposal has been advanced as a solution to the

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cooperative tax problem, it raises issues of general tax policy which are outside the scope of this report and hence will not be given detailed consideration here. 1/

This report examines the character and background of the present tax treatment of farm cooperatives, considers the extent to which these associations currently enjoy tax advantages over other corporate enterprises, and analyzes some of the proposals which have been advanced for increasing taxes on cooperatives. Section II describes the structure, purpose, and importance of farm cooperatives, the ways in which they conduct their business operations, and how they serve their farmer-members. Section III develops the background of the present tax treatment, outlines the scope of the exemption and the patronage-dividend exclusion, and discusses the benefits derived from each. Section IV considers various proposed changes in the present tax treatment, including the repeal of the exemption, the inclusion of patronage dividends in the gross income of the association, and the subjection of cooperative associations to either a gross receipts tax or a tax based on invested capital in lieu of the corporation income tax. The report contains no policy recommendations, but considerations relevant to the formulation of tax policy are discussed.

No attempt is made in this report to appraise either the economic or the social contribution of the farm cooperative movement to the Nation as a whole, or to determine the extent to which these organizations either deserve or need assistance from the Federal Government.

II. Purpose, structure, and importance of farmers' cooperative associations

A. Purpose and structure

The agricultural cooperative movement in the United States is more than a century old. Cooperative marketing and purchasing organizations grew out of the economic necessity of individual farmers' finding an efficient method of marketing their crops and of purchasing their supplies. Handicapped by their isolation, by their lack of knowledge of the markets in which they had to deal, by their weak bargaining position in those markets, and by their lack of capital, farmers sought to improve their economic situation through group action.

1/ For a discussion of issues relating to the taxation of corporate profits, see The Postwar Corporation Tax Structure (Treasury Department, Division of Tax Research, 1946). The proposal to allow corporations a deduction or credit for dividends paid is discussed in that report at pp. 37-46.

Over the years, farmers' cooperative associations have grown in strength and numbers and have expanded the scope of their activities. They have received a variety of financial and other assistance from the Federal Government. 1/

The incorporated cooperative association, like any other corporation, is an artificial entity created by law with a life independent of the people who own, manage, and do business with it. Moreover, like other incorporated enterprises organized to carry on some form of business activity, the farm cooperative has a business purpose. It exists to serve its farmer members and to increase the profits they derive from farming. In this respect, the cooperatives differ from charitable and educational corporations whose primary functions are not directed to the economic advantage of their owners and organizers.

Although farm cooperatives are in many ways similar to ordinary business corporations, there is one significant difference. The owners of the cooperatives are also their principal patrons. While most cooperatives issue capital stock, as do ordinary corporations, the dividends paid on such shares (and on preferred shares, if these are issued) are strictly limited. Moreover, there are many non-stock associations which issue membership certificates as evidences of "residual equities" in their assets. Whether the association is organized with or without stock, however, all amounts remaining after provision for limited dividends on equity capital and for necessary reserves are returnable to the patrons of the association in proportion to the use made of the association by each. 2/ Amounts so returned to patrons are usually called patronage refunds or patronage dividends. 3/

1/ For a history of the development of farm cooperatives in the United States, see R. H. Ellsworth, The Story of Farmers' Cooperatives (Farm Credit Administration, Circular E-23).

2/ In order for an organization to be considered a cooperative, it is not necessary for all classes of patrons to have equal ownership rights. Some cooperatives provide different participations for member patrons (i.e., those who are also capital contributors) and non-member patrons. This practice, however, is more common among British cooperatives than those in the United States.

3/ There is, however, no uniformity among cooperatives in the terminology applied to these distributions. In fact, there is a growing tendency among cooperative accountants to abandon the term "patronage dividend" in favor of what they consider to be more expressive terms. The term "patronage dividend" is used in this report solely because of its acceptance in ordinary usage and not to imply any analogy to ordinary corporation dividends.

B. Economic importance of farm cooperatives 1/

At the present time, about 10,150 farmers' marketing and purchasing associations are active in the United States. One out of every three farmers is believed to be a member of at least one cooperative. About 73 percent of the associations (7,400 organizations) are engaged primarily in the marketing of farm products and the remaining 27 percent (2,750 organizations) primarily in purchasing farm supplies. These cooperatives are spread widely throughout the country, although there is a natural concentration in such major agricultural States as California, Minnesota, Illinois, Iowa, and Wisconsin.

In the 1944-45 marketing season, the 10,150 farm cooperatives had an aggregate volume of business (valued at the farm level) of $5,645 million, of which 81 percent ($4,550 million) represented farm products marketed and 19 percent ($1,095 million) farm supplies purchased. These cooperatives handled at some stage in the marketing process during that season about 60 percent of citrus fruits and cranberries, 50 percent of dried skim milk and fluid milk, 40 percent of creamery butter, and 20 percent of livestock marketed through public commercial market channels. In their purchasing operations, farm cooperatives accounted also for substantial proportions of the feed, fertilizer, and automotive fuels and lubricants used by farmers. The number of farmers' cooperative marketing and purchasing associations, the number of their members, and their dollar volume of business for 1944-45 by type of product are shown in Appendix B.

C. Variations in organizations and operations

Ninety-four percent of the 10,150 farm cooperatives are local associations, whose operations are confined to the relatively small area in which farmers can be conveniently served from a single outlet. Some of these are more or less informal associations formed for buying and selling in carload lots, but many provide warehouse and storage facilities, basic marketing services (such as grading, packing, or elementary processing), or formal retailing and service stores. Some are purely bargaining associations, leaving each farmer to make his own sale; others act solely as brokers between the farmer and purchaser of his products (or the seller of his supplies); still others take title to the goods handled. Control over such associations is usually vested in a board of directors elected directly by the members. In the election of directors each member usually has but one vote irrespective of the number of shares owned, and voting by proxy is generally not allowed.

1/ All data on farm cooperatives obtained from the U. S. Department of Agriculture, Farm Credit Administration, Cooperative Research and Service Division.

Although the vast bulk of the associations are small and local in character, many of them are either members of, or affiliated with, large-scale centralized and federated cooperative associations. The centralized associations are regional associations operating over a larger area than can be served by a local association. As in the case of the latter, however, the members of the centralized associations are individual producers who directly select the board of directors of the association. 1/ The federated associations are also regional or large-scale organizations, but their members are wholly or predominantly cooperative associations and in some cases are cooperative associations that are themselves federations. Federations are controlled by boards of directors chosen by duly elected representatives of the members in the local organizations.

In 1942-43 (the latest year for which data of this sort are available) about 43 percent of the total volume of marketing done by farm cooperatives was accounted for by 48 federated or centralized regional cooperatives, each with a business volume of more than $10 million. In addition, there were 10 federated or centralized regional purchasing cooperatives with an annual volume of more than $10 million each, which accounted for about 35 percent of the total purchasing volume of all farm cooperatives. These large-scale regional cooperatives, and the inter-regional associations formed in turn by them, frequently carry cooperation further along the chain of distribution, sometimes to the ultimate consumer (in the case of marketing associations) or to the basic manufacturing stages (in the case of purchasing associations). Among the purchasing cooperatives these operations are associated mainly with the production of feed and fertilizer, although a number of paint factories, sawmills, and oil refineries are operated by cooperative associations. Among the marketing cooperatives, advanced processing is carried on mainly in creameries and cheese factories, cotton gins, canneries, and dehydrating plants, although a few associations operate flour and cereal mills, wineries, sugar mills, and nut processing and packaging plants. Despite the wide variety of activities in which farm cooperatives are currently engaged, it appears that the number of true manufacturing plants owned and operated by them is still very small, and that cooperative manufacturing is economically significant only in a very few lines. 2/

D. How cooperatives serve the farmer

Farmers' marketing and purchasing associations are organized for the purpose of increasing receipts from the sale of farm products and lowering the costs of farm supplies. The ultimate purpose of these associations is, therefore, to increase farm profits.

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INTENTIONAL SECOND EXPOSURE

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There are various ways in which farm cooperatives can increase farm income. They may lower the cost of farm supplies by purchasing in bulk and by taking advantage of trade discounts. Purchasing associations with experienced, full-time managers can protect their members against adulterated and inferior merchandise, and can assist them in the selection of those supplies which are best suited to the needs of particular farms. They can time their purchases to take advantage of favorable market situations and exercise a wider choice in the selection of sources of supply. They may extend the scope of their operations from merely trading to manufacturing and extraction. Marketing cooperatives may increase receipts from the sale of farm products by providing their members with more efficient and economical sales services. Products may be stored, graded and further processed to increase their salability. Competition between farmers in a particular area may be reduced and their bargaining position in the principal markets for their products improved; trademarks or trade names may be established, and the quality of products may be improved.

In addition, the capital contributions of farmers to cooperatives enable them to share in the normal profits derived from the handling of farm products and farm supplies. Among the marketing associations, these investments have taken such forms as grain elevators, cotton gins and cottonseed oil mills, creameries and cheese factories, and in the case of the purchasing associations, investments have been made in warehouses, retail outlets, fertilizer factories, and oil refineries.

Not all of the income derived by the members of a cooperative from the association is directly attributable to their patronage. Some cooperatives do substantial amounts of business with non-members who are not permitted to share in patronage dividends. Others have bought or sold agricultural products for the Federal Government under terms which have permitted the net proceeds from these sales to be distributed to the ordinary patron along with their own patronage refunds. 1/

Although there are few services which the cooperative associations provide to farmers that ordinary corporations could not provide, the patronage dividend which they hold out to their patrons is a powerful competitive force. Once a cooperative association has established itself, farmers frequently find that they can do business with private firms on terms which are equally favorable to those on which they deal with the cooperative. The very presence of the cooperative as a competitor in a given market often enables all the farmers in that

1/ In practice, this appears to have been true mainly in the case of service cooperatives. Marketing contracts with the Federal Government usually provide for refunds to the Government.

market to sell and buy on better terms than they could in its absence. The benefits of cooperation are, therefore, not necessarily limited to those farmers who patronize cooperative associations.

Although the ordinary corporation usually can and frequently does perform the same services for farmers as those performed by the cooperative association, it must be recognized that the primary objective of the ordinary corporation is that of making a profit for its owners. There is, therefore, an inevitable conflict of interest between the ordinary corporation as buyer or seller and the farmers with whom it does business. The cooperative, on the other hand, is usually so organized that the interest of each member as an owner is at least roughly proportional to his interest as a customer. This means that there is no conflict between the objectives of the cooperative and of its member-patrons.

E. How farmers share in the benefits of cooperation

The individual farmer is ordinarily both an investor in, and a patron of, the cooperative association of which he is a member. His contribution to the success of the venture is, therefore, a twofold one, involving both his capital and his patronage. As an investor in the association, he is promised a limited return on his equity in the association. As a patron, he is promised his proportionate share in the savings made possible by his contribution to the pooling of purchases or sales and in any income which the association may derive from its activities.

The individual farmer's share—as patron—in the success of the cooperative association of which he is a member may or may not be reflected in the size of his patronage dividend. The patronage dividend payments received by the farmer at the close of the year may not fully reflect his proportionate share in the gains from cooperative buying or selling. The size of the patronage dividend is determined by the particular pricing methods of the association, as well as by its efficiency in buying and selling.

In this connection, three distinct types of pricing policies may be noted. In the first category is found the so-called Rochdale type of pricing policy, the distinguishing feature of which is the fact that the prices at which the cooperative buys from and sells to the farmer are the going market prices for the commodities handled. Patronage dividend payments in this case may therefore be said to represent the difference between such prices and the necessary expenses of the association. The second category covers those situations where it is not feasible to follow a market price policy, yet where the cooperative is under the legal obligation to return all net proceeds to its patrons, and may therefore pay patronage dividends.

INTENTIONAL SECOND EXPOSURE

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In addition, the capital contributions of farmers to cooperatives enable them to share in the normal profits derived from the handling of farm products and farm supplies. Among the marketing associations, these investments have taken such forms as grain elevators, cotton gins and cottonseed oil mills, creameries and cheese factories, and in the case of the purchasing associations, investments have been made in warehouses, retail outlets, fertilizer factories, and oil refineries.

Not all of the income derived by the members of a cooperative from the association is directly attributable to their patronage. Some cooperatives do substantial amounts of business with non-members who are not permitted to share in patronage dividends. Others have bought or sold agricultural products for the Federal Government under terms which have permitted the net proceeds from these sales to be distributed to the ordinary patron along with their own patronage refunds. 1/

Although there are few services which the cooperative associations provide to farmers that ordinary corporations could not provide, the patronage dividend which they hold out to their patrons is a powerful competitive force. Once a cooperative association has established itself, farmers frequently find that they can do business with private firms on terms which are equally favorable to those on which they deal with the cooperative. The very presence of the cooperative as a competitor in a given market often enables all the farmers in that

1/ In practice, this appears to have been true mainly in the case of service cooperatives. Marketing contracts with the Federal Government usually provide for refunds to the Government.

market to sell and buy on better terms than they could in its absence. The benefits of cooperation are, therefore, not necessarily limited to those farmers who patronize cooperative associations.

Although the ordinary corporation usually can and frequently does perform the same services for farmers as those performed by the cooperative association, it must be recognized that the primary objective of the ordinary corporation is that of making a profit for its owners. There is, therefore, an inevitable conflict of interest between the ordinary corporation as buyer or seller and the farmers with whom it does business. The cooperative, on the other hand, is usually so organized that the interest of each member as an owner is at least roughly proportional to his interest as a customer. This means that there is no conflict between the objectives of the cooperative and of its member-patrons.

E. How farmers share in the benefits of cooperation

The individual farmer is ordinarily both an investor in, and a patron of, the cooperative association of which he is a member. His contribution to the success of the venture is, therefore, a twofold one, involving both his capital and his patronage. As an investor in the association, he is promised a limited return on his equity in the association. As a patron, he is promised his proportionate share in the savings made possible by his contribution to the pooling of purchases or sales and in any income which the association may derive from its activities.

The individual farmer's share—as patron—in the success of the cooperative association of which he is a member may or may not be reflected in the size of his patronage dividend. The patronage dividend payments received by the farmer at the close of the year may not fully reflect his proportionate share in the gains from cooperative buying or selling. The size of the patronage dividend is determined by the particular pricing methods of the association, as well as by its efficiency in buying and selling.

In this connection, three distinct types of pricing policies may be noted. In the first category is found the so-called Rochdale type of pricing policy, the distinguishing feature of which is the fact that the prices at which the cooperative buys from and sells to the farmer are the going market prices for the commodities handled. Patronage dividend payments in this case may therefore be said to represent the difference between such prices and the necessary expenses of the association. The second category covers those situations where it is not feasible to follow a market price policy, yet where the cooperative is under the legal obligation to return all net proceeds to its patrons, and may therefore pay patronage dividends.

In some cases, for example, there may be no clearly established market price because of lack of competition; and the prices paid by a marketing association may be more or less arbitrary. Final payments to patrons in such cases are an adjustment which does not accurately measure the gain from cooperative buying or selling. The third category includes those cases where a purchasing association follows the practice of selling at cost-plus-estimated expenses or where a marketing association pays a price based on sales value minus estimated cost of operation. In such cases, patronage dividends will be paid infrequently if at all. Whatever benefits the patron may derive from his dealings with the association will be currently reflected in the higher prices he receives for his product or the lower prices he pays for his supplies.

In practice, it appears that a large proportion of cooperatives return the benefits of cooperation to their members without the use of patronage dividends. The prevailing-price-patronage-dividend technique originated among the purchasing cooperatives and has not been universally adopted by marketing associations, although charters and by-laws permit its use. Even among purchasing cooperatives, a few of the associations sell directly at cost-plus-estimated expenses, or at a price below the market, but high enough to yield small patronage dividends. 1/

The typical marketing cooperative operates under a marketing contract in which the association undertakes to pay the farmer the entire proceeds from the sale of his product, less certain deductions for handling expenses and for capital contributions. 2/ In some cases, the farmer receives the full going local price upon delivery to the cooperative, but more often he gets only a down payment, the balance to be paid in successive installments as the crop is sold. The size of the down payment is determined by custom or by the financial condition of the association and does not represent what the farmer could have received had he sold his product outright to private buyers. The sum of the installments represents the net or adjusted price of the product after all or most of the cooperative's expenses have been deducted. Usually, no attempt is made to segregate amounts representing the local market price of the product from the net distributed proceeds of the cooperative.

1/ The practice of pricing on a cost-plus-expenses basis was common 20 years ago, but has been largely abandoned because of the resentment of competitors.

2/ Since these capital payments are deducted from gross sales proceeds, they are not non-cash patronage dividends, but direct capital contributions or assessments on a patronage basis.

No current data are available showing how many cooperatives follow the prevailing-price-patronage-dividend method, but some information is available from a statistical study of cooperatives made in 1936. 1/ In that year, there were 10,752 farmers' marketing and purchasing associations. Of the 7,428 associations engaged primarily in marketing, only 2,339, or 32 percent, reported payment of patronage dividends. Of the 3,324 purchasing associations, 54 percent reported patronage dividends. The combined ratio for all associations was about 35 percent. These figures are, of course, not conclusive, since some cooperatives which ordinarily pay patronage dividends may have failed to do so in 1936. Moreover, the aggregate figures do not give sufficient weight to the large associations and to those in the more important marketing fields where patronage dividends are the rule. Nevertheless, these 1936 data indicate that a significant proportion of cooperatives do not distribute any of the benefits of cooperation in the form of patronage dividends.

One advantage of operating on the prevailing-price method is that it enables the associations to use their net margins as a source of capital. Patronage dividends are not always paid out in cash. Under the by-laws of many associations, the patrons are either required or given the option to leave amounts due them with the association. In lieu of cash, the patron may receive an interest-bearing or non-interest-bearing certificate of indebtedness, a certificate of equity, or additional shares of capital stock. This enables the association to build up its working capital and, over a period of time, gives the patron an investment in the association proportional to the amounts of business he does with it. 2/

Some of the benefits derived by the patrons from their dealings with cooperative associations accrue only indirectly. Cooperatives are permitted to obtain capital funds by setting up reserves without making a corresponding non-cash distribution to their patrons. Most of the State laws under which farm cooperatives operate require certain amounts to be set aside for general contingencies. In addition to these mandatory reserves, however, cooperatives frequently accumulate reserves for specific contingencies and other purposes.

1/ Statistical Handbook of Farmers' Cooperatives, Farm Credit Administration, Cooperative Division, Washington, 1938. Bulletin 26.

2/ A substantial number of associations issue capital stock, certificates or other evidences of equity interest or simple book credits in connection with the revolving-fund method of financing. Where the revolving-fund method is used, the oldest outstanding capital is retired after a sufficient amount of capital has been built up. Thereafter, as additional capital becomes available, a similar amount of older capital is retired.

III. Present tax treatment of farm cooperatives under the Federal income tax

A. Background of the present treatment

The Act of 1913, which imposed the first income tax under the Sixteenth Amendment, made no specific reference to farmers' cooperative associations, but it did expressly exempt from tax "agricultural and horticultural organizations." The Treasury Department construed this exemption to include all farmer and fruit grower associations without capital stock represented by shares, if their purpose was to promote the mutual benefit of their members in growing, harvesting, and marketing their products and if their income was derived wholly from membership fees, dues, and assessments to meet necessary expenses. 1/

The 1913 Act also exempted mutual savings banks not having any capital stock represented by shares. However, it prescribed a rather different treatment for mutual fire insurance companies whose members made premium deposits to provide for losses and expenses. These insurance companies were not required to include in taxable income any portion of the premiums returned to their policyholders as so-called policy dividends. Income from other sources and premium payments retained by these companies for purposes other than the payment of losses and expenses and reinsurance reserves were, however, taxable. The Treasury by analogy adopted in 1914 a similar rule for farm cooperative associations which were not eligible for exemption under the 1913 Act and permitted them to exclude patronage dividends from gross income. 2/

In 1916, Congress specifically extended the exemption to "farmers', fruit growers', or like associations, organized and operated as the sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales less necessary selling expenses, on the basis of the quantity of produce furnished by them." 3/ Express statutory exemption was granted on the same terms to agricultural purchasing cooperatives in 1921. 4/ In order to qualify for the exemption under the 1916 Act, a cooperative had to satisfy the Commissioner of Internal Revenue that its business was that of marketing products for its members and that the entire proceeds of such marketing had to be turned back or paid to such members on the basis of the quantity of produce turned in by them. 5/ The Regulations under the 1916 Act, like those under the 1913 Act, provided that any cooperative

1/ T.D. 1742.
2/ See T.D. 1996.
3/ Section 11(a) Eleventh, Revenue Act of 1916.
4/ Section 231(11), Revenue Act of 1921.
5/ Regulations 33, Art. 75.

association which could not qualify for the exemption, because it did not act strictly as agent but purchased produce from members with a view toward selling it for gain, might nevertheless exclude from gross income all amounts paid to members on the basis of quantity of goods handled for them. Thus one kind of tax treatment was prescribed for the so-called agency-type cooperative which was deemed not to have income, and a different treatment for the association taking title to the commodities handled but under contract to return to its patrons on the basis of patronage the bulk of its net proceeds.

In the decade between 1916 and 1926, there were substantial changes in the tax statutes and Treasury Regulations with respect to farm cooperatives. In the belief that Congress desired the exemption to be construed broadly, the Treasury ruled that an otherwise exempt cooperative would not be denied exemption because it had outstanding capital stock on which it paid a fixed dividend amounting to the legal rate of interest, provided that all such capital stock was owned by farmers. 1/ Somewhat later it was held that an otherwise exempt cooperative could accumulate and maintain a reserve required by State laws as well as a fixed fund or surplus for the erection of buildings and facilities required in its business, without losing its exempt status. 2/ Still later the Treasury ruled in effect that an exempt marketing cooperative need not be operated strictly as an agent of its members but could take title to commodities without losing its exempt status, provided that it turned back to producers the proceeds of the sales of their products, less necessary operating expenses, on the basis of produce furnished by them. 3/

In the Revenue Act of 1926, Congress incorporated these administrative rulings into statutory law and at the same time established clear-cut tests of eligibility for the exemption. These statutory provisions have remained virtually intact to the present day. Although there has been no legislation bearing directly on the exclusion of patronage dividends, the non-exempt associations have continued to enjoy the right of excluding such payments from their taxable income.

With this brief historical introduction, it is now possible to proceed to the discussion of the exemption and exclusion in their present-day application.

1/ Regulations 45, Art. 522.
2/ Regulations 62 (1922 ed), Art. 522.
3/ Regulations 65, Art. 522.

B. Tax exemption

1. Eligibility for the exemption

Eligibility of farmers' cooperative associations for income tax exemption is strictly limited by statutory provisions and administrative interpretations. 1/ The precise number of exempt and non-exempt associations is not known, but one may infer from the number of Form 990 returns filed by farm cooperative associations for 1943, that between 5,000 and 6,000, or a little more than one-half of the active associations, are today exempt. 2/

The exemption applies only to farmers' associations organized and operated on a cooperative basis which (a) market the products of members or other producers and return to them the proceeds of sales less necessary marketing expense on the basis of the quantity or value of the products furnished, or (b) purchase supplies and equipment for their members or others at cost plus necessary expenses.

With respect to both marketing and purchasing associations, the statutes and regulations require that there shall be no discrimination between members and non-members in returning the net proceeds to the patrons in proportion to the produce marketed or supplies purchased. 3/ In other words, the members of exempt cooperatives are not allowed to make a profit out of the business done with non-members. Moreover, the statute specifically provides that the exemption shall be lost if the association markets or purchases more products for non-members than it does for members. 4/ Purchasing associations lose their exemption if more than 15 percent of their purchases are for persons who are neither members nor producers.

1/ See Internal Revenue Code, sec. 101(12) and Regulations 111, sec. 29.101(12)

2/ Form 990 returns are required to be filed by all organizations exempt from tax under section 101 of the Internal Revenue Code except certain religious, charitable, and educational organizations. (Internal Revenue Code, sec. 54(f).) A total of 5,595 Form 990 returns were filed by tax-exempt farmers' cooperatives for income years beginning in 1943, which is the latest year for which the returns have been tabulated. Although it is believed that most associations required to file did so, it is impossible to say how complete the coverage of these information returns actually was. Appendix E shows a distribution of returns of exempt farmers' cooperatives for 1943 (returns received through December 31, 1944) by size of gross income and receipts and of total assets. It has not been possible to segregate the tax returns of taxable cooperatives from those of ordinary corporations, but a question has been added to the 1946 corporation income tax return (Form 1120), which will permit such a segregation for 1946 and later years.

3/ Under the Regulations, the necessary condition of equal treatment of member and non-member patrons is not violated if the association credits the patronage dividends of non-members toward the purchase price of a share of stock.

4/ A member is defined in the Regulations as anyone who shares in the profits of the association and is entitled to participate in the management of the association. In a stock cooperative, therefore, the members are the owners of the voting common stock, and in a non-stock cooperative they are those with membership certificates and the right to vote.

The statute limits the method of financing open to exempt cooperatives. If capital is raised by the sale of stock, substantially all the stock (except non-voting, non-participating preferred stock) must be held by farmers, and dividend rates must be limited to no more than 8 percent or the legal rate of interest in the State of incorporation, whichever is greater.

Thus, in order to enjoy tax exemption, cooperative associations must be controlled by their farmer patrons and must do most of their business with them. Business with the Federal Government, or its agencies, is, however, disregarded in determining the right to exemption.

The Treasury has held that exemption is not confined to farmers' cooperatives whose members are actually farmers, but extends to federated farmers' cooperatives and subsidiaries of exempt cooperatives which meet the statutory tests. 1/ Exemption has been granted to marketing and purchasing associations whose activities include manufacturing or processing where these activities are necessary to the efficient discharge of the basic functions of the organization. Supplies and equipment purchased have been defined as including "groceries and all other goods and merchandise used by farmers in the operation or maintenance of a farm or farmer's household." 2/

2. Benefits derived from the exemption

The benefits derived from outright tax exemption substantially overlap those attributable to the patronage-dividend exclusion. Nevertheless, there are certain advantages which would be lost to exempt cooperatives if the exemption were repealed and the exclusion continued. Some of the more important of these advantages will be discussed below.

a. Exemption of income paid out as dividends on capital stock

In 1936, the latest year for which complete data are available, about 80 percent of all farm cooperative associations were organized with capital stock. 3/ However, it is reported that there is a growing tendency to prefer the non-stock type of associations. Although the

1/ Under Internal Revenue Code, sec.101(13), an exempt farmers' cooperative may also organize and operate a corporation for the purpose of financing ordinary crop operations, provided the requirements concerning control, dividend rate, and reserves described in the previous paragraphs are met.

2/ Regulations 111, sec.29.101(12)-1(b).

3/ A Statistical Handbook of Farmers' Cooperatives, Farm Credit Administration, Cooperative Division, Washington, D.C. Bulletin No. 26, November 1938, p.8.

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In countering the argument that they derive a substantial advantage from their ability to distribute tax-free dividends to stockholders, the cooperatives advance an offsetting consideration. They argue that their dividend payments are of a completely different economic character from those paid by ordinary corporations in that they represent essentially only a fair "wage" for the use of capital. In a corporation the stockholders may receive (subject to declaration by the directors) all of the net profits of the business after payment of expenses and satisfaction of creditors. In a cooperative, however, net proceeds above limited dividends are distributed on the basis of patronage rather than stock ownership. Accordingly, it has been argued that the incidents of ownership are vested in the members as customers rather than as stockholders and that the limited dividends which must be paid on capital contributed to the enterprise are an expense or charge against earnings and so are akin to an interest payment. In rebuttal to this argument, however, it may be pointed out that, except in the case of certain public utility corporations, 3/ ordinary corporations are not allowed a deduction for the limited dividends paid on preferred stock.

b. Exemption of income retained as reserves

Cooperatives may accumulate capital funds out of operating margins in two ways. First, they may retain all or part of the cash proceeds from operations, while still fulfilling their contractual obligation to return net operating margins to patrons. In lieu of cash payments, the by-laws of cooperatives usually permit them to distribute patronage dividends in the form of some evidence of the patrons' equity in the retained funds or to make book credits to patrons' accounts.

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Second, cooperatives may also retain a part of their annual net proceeds as reserves before computing the amounts which must be returned as patronage dividends. Under a recent court decision, exempt cooperatives are required to allocate on their books to current-year patrons pro rata shares in such reserves, so that member-patrons will not gain at the expense of non-member-patrons upon dissolution of the association. 1/ However, the mere fact of allocation does not make such reserves equivalent to non-cash patronage dividends, and the Bureau of Internal Revenue has continued to distinguish between allocated reserves and non-cash patronage dividends.

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Reserves are set up for a variety of purposes. Section 101(12) expressly permits exempt cooperatives to accumulate the general contingency reserves which cooperatives are required to build up by provisions of most State laws. Additions to such reserves are sometimes limited by the State statutes to a percentage of the net margin for the year, and usually the total reserve which must be accumulated is limited to a percentage of total capitalization. 2/ Cooperative accounting technically does not admit a surplus account, but the mandatory reserve serves essentially the same purpose under a different name. 3/

1/ Fertile Cooperative Dairy Association v. Collector, 33 F. Supp. 712, Aff, 119 F. (2d) 274.

2/ In New York, for example, cooperatives (organized under one cooperative statute) are required to set aside 10 percent of earnings until the reserve reaches 30 percent of paid-in capital. Although maintenance of the reserves is mandatory, the funds are not required to be permanently and physcially segregated. Accumulations are available for use in the business.

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In addition to the mandatory general reserves, cooperatives are also allowed to accumulate certain other reserves for specific purposes. The statute provides that exemption shall not be denied if a cooperative maintains "a reserve required by State law or a reasonable reserve for any necessary purpose." In administering this provision, the Commissioner has not emphasized the word "or" but has allowed cooperatives with mandatory State law reserves to accumulate "reasonable and necessary" reserves as well. The terms "necessary purpose" and "reasonable reserve" are construed in the light of the purpose to be accomplished, and in case of dispute over specific reserves the burden of proving necessity and reasonableness is on the association.

In practice, reasonable and necessary non-mandatory reserves appear to be of two distinct types. First, there are specific contingency reserves, i.e., reserves for foreseeable losses or expenses which are properly chargeable in whole or in part to the current accounting period. To the extent a cooperative sets up reserves representing bona fide anticipations of losses, such reserves are essentially only averaging devices which have their counterpart in the carryforwards and carrybacks now allowed ordinary business and non-exempt cooperatives. 1/

Second, there are "reasonable and necessary" reserves for expansion purposes. The Regulations provide that "the accumulation and maintenance of a reserve . . . to provide for the erection of buildings and facilities required in the business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption." 2/ Consequently, it is possible under existing law for an exempt cooperative association to reinvest a substantial portion of its earnings in plant and equipment without either the association or the patron being taxable thereon.

c. Other advantages

Relief of exempt cooperatives from tax on dividends on capital stock and on reserves constitutes the principal advantage attributable to the exemption. There are, however, certain lesser advantages which may be touched on briefly.

1/ Many cooperatives assert that if the contingency does not arise, their standard procedure is to return the reserve to the patrons who contributed to it as soon as this fact is realized.

2/ Regulations 111, sec. 29.101(12)-1.

(1) Business with the Federal Government

The statute provides that buying or selling commodities on behalf of the "United States or any of its agencies shall be disregarded in determining the right to exemption." Whereas, non-exempt cooperatives would be taxable on that portion of its net proceeds representing profits on Government business (unless actually returned to the Government), the exempt cooperative is not so taxable. It should be noted, however, that some exempt cooperatives actually have made a practice of returning the net proceeds to the Government as if it were an ordinary patron or of providing service to the Government on a direct cost-plus-expenses basis. Little information is available as to the general practice in this respect.

(2) Emergency purchases

As a general rule, an exempt marketing cooperative must restrict its activities to the actual marketing of agricultural products and must act only on behalf of farmers. The courts and the Bureau of Internal Revenue, however, have enunciated the principle that the exemption provisions should not be construed in such a way as to prevent the organization from carrying on its functions successfully. Consequently, the Bureau has made an exception to the general rule in cases where the amount of non-farm products marketed is small and where the handling of such items is essential to the efficient operation of the business. Exception is also usually made where products are purchased from dealers for a limited time only in order to fulfill delivery contracts or other emergency purposes. 1/ Patronage dividends are not usually paid to such non-member suppliers or suppliers of non-agricultural products. Limited amounts of ordinary commercial profits thus may escape taxation.

(3) Non-operating income

Non-operating income such as interest on bank deposits or on investments, dividends, and capital gains would probably be taxable to the cooperative in the absence of the exemption. However, the amount of income which exempt cooperatives derive from these sources is extremely small. 2/

1/ Particular cases must be passed on by the Bureau of Internal Revenue. Moreover, in the nature of the case such transactions often involve losses.

2/ The problem of treatment of income derived from investments or from sources extraneous to the principal activity of the organization arises in the case of virtually all organizations exempt under sec. 101 of the Internal Revenue Code. Since this is a general problem, which is most important in the case of organizations other than farm cooperatives, it is not considered in detail in this report.

3. Disadvantages of the exemption

The exemption also involves certain disadvantages for cooperatives. This is suggested by the fact that only about half of the farm cooperatives attempt to meet the statutory requirements. One of the most important disadvantages is the requirement that exempt associations must not discriminate against non-members in paying patronage dividends. Another disadvantage in the case of marketing cooperatives is the prohibition of dealings with non-producers. Similarly, the restriction of non-farmer purchasing to 15 percent of total purchasing has been said to act as a limitation on the growth and expansion of some of the most successful units of the cooperative movement.

C. Patronage-dividend exclusion

1. Scope of the exclusion

The exclusion of patronage dividends from corporate gross income is not the exclusive privilege of cooperation associations. Any corporation making payments to its customers under the conditions prescribed by the Commissioner of Internal Revenue and the courts is granted the same treatment. It should be noted, however, that in the case of cooperatives, unlike the case of the typical ordinary corporation, patrons receiving rebates are also the owners of the business.

The conditions which the cooperative associations must meet if refunds made to their patrons are to be excluded from the gross income of the association may be briefly stated. First, there must have existed at the time of the transaction with the patrons a contractual or other definite obligation on the part of the cooperative to return any net proceeds to him in proportion to patronage without further corporate action. Second, if only members of the association are eligible to receive patronage dividends, exclusion is not allowed on that portion of such distribution which represents profits from transactions with non-members. On the other hand, it is held to be immaterial whether refunds are distributed in the form of cash, stock, certificates of indebtedness, or credit notices. All such forms of payment are regarded as the equivalent of cash distributions in the hands of patrons, the theory being that they are cash payments automatically re-invested under provisions of the charter, by-laws, or other contracts previously agreed to by the patrons.

2. Benefits derived from the exclusion

The tax benefits which the cooperative associations derive from the exclusion of patronage dividends from gross income depend, of course, on the extent to which these payments are in fact analogous to a distribution of earnings and profits by an ordinary corporation.

To the extent that patronage dividends represent the patrons' share in the association's economic income, their exclusion from the income of the cooperative can be said to give farm cooperatives tax benefits comparable to those enjoyed by unincorporated firms in their freedom from taxation on business profits as such. As regards cash distribution, the exclusion enables the patrons to receive their respective shares of the association's net proceeds undiminished by the corporation income tax. As regards non-cash distributions, the exclusion may place at the disposal of the association the full amount of its undistributed net proceeds. In both cases, the patrons themselves will be taxed on the amounts received by them in cash or non-cash distributions. But unless the patrons are, on the average, subject to higher marginal rates of income tax than those applicable to the association, the total tax liabilities on the association's undistributed net proceeds will always be less than if the exclusion of non-cash patronage dividends were disallowed and patrons were taxed only on cash distributions.

To the extent, however, that patronage dividends are composed of elements other than the patrons' share in the association's economic income, their exclusion from the income of the cooperative confers no advantage on cooperatives as compared with ordinary corporations. As the discussion in a later section will indicate in detail, patronage dividends often include elements analogous to items included in cost of goods sold in the case of ordinary corporations. Moreover, non-cash patronage dividends may serve merely as evidence of the capital contributions of members of cooperatives. The amount of excluded patronage dividends is not an acceptable measure of the amount of true net income escaping taxation at the cooperative level by reason of the exclusion.

D. Effect of present tax treatment on competitive position of farm cooperatives

It has been charged that the complete or virtual exemption of farm cooperatives from income tax has given these associations an unfair competitive advantage over their corporate competitors. Specifically, it is contended that, because of their more favorable tax treatment, cooperatives have been able (1) to pay larger refunds and so attract more patronage than they could otherwise command, and (2) to retain a larger percentage of their earnings and so expand more rapidly than would be possible if their income were fully taxable.

In reply to the first of these charges, the cooperatives themselves deny that their favorable tax status has had any material effect upon their volume of business. They contend that any advantages they enjoy over ordinary business firms, either as buyers of farm products or as sellers of farm supplies, stem primarily from the cooperative idea itself rather than from any pecuniary advantages to be gained from dealing with a tax-free or virtually tax-free organization.

The issue raised by this argument cannot be easily resolved. On the one hand, there appear to be few instances where cooperatives have used their tax immunity as an instrument of price warfare. Indeed, it would be difficult for them to do so, since the more they cut prices, the smaller will be their economic income and, consequently, their tax advantage. In a situation where both cooperatives and their corporate competitors were selling at cost, the tax advantage would, of course, entirely disappear. Moreover, it appears that, in many markets where cooperative associations compete most directly with ordinary corporations, they do not outbid their competitors but make it a practice to charge the same prices. On the other hand, it is undoubtedly true that the prospect of patronage dividends has been a significant factor in building up the membership of farm cooperatives. To the extent that the special tax status of cooperative associations has permitted payment of larger patronage dividends, it may therefore have been a factor in the growth of membership of cooperatives. In this connection, however, the cooperatives argue that patronage dividends are used mainly as a matter of convenience and that the same results could be closely approximated by other methods of sharing benefits which do not depend on the exemption or exclusion.

The charge that farm cooperatives, because of their favored tax status, have been able to expand more rapidly out of earnings than their corporate competitors has been strongly pressed during recent years of high tax rates. During recent years, ordinary corporations were subject to high-rate income and excess-profits taxes which limited their ability to plough earnings back into the business. Farm cooperatives have been under no such restrictions on their use of funds, and many of them have taken advantage of the opportunities to finance acquisitions of plant and equipment out of retained net proceeds.

The cooperatives contend that non-cash patronage dividends are not analogous to the retained earnings of ordinary corporations, and argue that they represent capital contribution to the enterprise by the patrons. They also contend that any tax advantage which they may enjoy as the result of the exclusion of their retained net proceeds from gross income merely serves to offset their great disadvantages in obtaining equity capital. The associations point out that dividends on their stock are limited and that they cannot issue any security which corresponds with the common stock of ordinary corporations. Moreover, the market for such securities as they can issue is small and is composed largely of farmers who, at least prior to the war, had always been a poor source of equity capital.

Since the cooperative associations themselves must be presumed to earn something on their capital, the argument cannot be accepted that all retained net proceeds should be regarded as capital contributions. Concerning the disadvantages of the cooperative associations in seeking capital, it is probably true that these associations do not have easy access to the organized capital market as do the larger corporations. On the other hand, medium-size and small corporations also find it difficult to secure long-term capital funds.

In current discussions of the tax advantages enjoyed by cooperatives, much emphasis has been placed on the alleged rapid growth of these associations in recent years. While it is true that the dollar volume of business done by farm cooperatives has increased more than two and one-half times since 1939, it does not appear that the cooperatives as a whole have expanded their relative share of the market at the farm level. 1/

There has also been some discussion of the expansion of cooperatives into the field of manufacturing, and the charge is sometimes heard that the tax advantages enjoyed by these organizations are responsible for this development. It is not possible on the basis of existing information to determine exactly what relative gains cooperative manufacturing has made in recent years. The fragmentary data on dollar volume of production indicate a substantial increase in the value of production of cooperatives. 2/ But even if this dollar series were complete it would be of little significance unless compared with the dollar volume of competitors of cooperatives. In any event, the amount of manufacturing by cooperatives is small. 3/

1/ A statistical analysis of the relative growth of farm cooperatives between 1935 and 1943 is presented in Appendix C.

2/ See "Operation of Consumers' Cooperatives in 1944", U.S. Department of Labor, Bureau of Labor Statistics, Bulletin No. 843, p. 16. The value of production by all purchasing cooperatives (both farm and non-farm) increased from $31 million in 1941 to $65 million in 1944.

3/ An estimate of the number and types of productive plants operated by farm cooperatives in 1943 has been prepared by the Farm Credit Administration. These estimates are reproduced in Appendix D. Although additional cooperative facilities have, of course, been built or acquired in 1944 and 1945 (and some abandoned during this period), it is unlikely that the over-all pattern has changed materially.

INTENTIONAL SECOND EXPOSURE

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IV. Considerations relating to proposed changes in the present tax treatment of farm cooperatives

A. Changes proposed in the present treatment

There is little agreement among those who believe that farm cooperatives should be more heavily taxed as to the precise measures which should be adopted. Some would merely repeal the exemption. Others would require the inclusion of all patronage dividends in the gross income of the association; others would continue the exclusion of cash patronage dividends but would require the inclusion of non-cash patronage dividends. Still others would impose a special tax in lieu of income tax on these organizations. This special tax would be based either on some measure of invested capital or on gross receipts. These suggestions appear to be the major alternatives to a continuation of the present treatment. In this section, the arguments for and against each of these proposals are presented and the principal controversial issues which they raise are discussed.

B. Repeal of the exemption

1. Arguments for and against the exemption

The exemption of eligible farm cooperatives from income tax has been defended on the grounds that these associations (1) operate in the public interest, (2) are not themselves profit-making institutions, and (3) are more nearly analogous to partnerships than to ordinary corporations.

With respect to the first point, it has been argued that farm cooperatives, in improving the economic conditions of farmers and in raising the grade and quality of products for public consumption, have made substantial contributions to the general welfare. The special tax treatment accorded them has been defended as a return for services rendered to the public.

With respect to the second point, it has been contended that farm cooperatives should be differentiated from ordinary corporations because it is both their intent and practice to do business at cost. The farm cooperative has been likened to a piece of farm equipment owned jointly by a number of farmers. It has been argued that, at most, the cooperative should be regarded as an agent for its patrons, having no claim upon the income arising from its operations. In terms of this argument, the exemption has been defended on the grounds that there is really nothing to tax.

With respect to the third point, it has been contended that, despite the fact that cooperative association are in legal form corporations, they more nearly resemble partnerships than ordinary corporations. This contention has been supported by the assertion that members usually participate actively in the control of the association and that the activities of the association are closely integrated with their members' primary business of farm production. It has been pointed out that partnerships as such are not taxed on their incomes and argued that cooperatives should receive the same treatment. It is contended that application of the corporation income tax to cooperatives would result in an undesirable extension of the area of so-called double taxation of business income, at a time when many believe that the existing double taxation of distributed profits of ordinary corporations should be eliminated.

The exemption has also been defended, even by those who concede that dividends on capital stock and reserves are properly taxable as income of the association, by the contention that the amount of revenue involved is not large enough to justify the trouble and expense of its collection. It has been argued that so long as no attempt is made to tax patronage dividends, the Government would gain little if anything from repeal of the exemption. 1/

On the other hand, the principal argument that has been advanced against the exemption is that cooperatives perform the same economic function as ordinary companies, that they are organized as corporations with the same powers and obligations as ordinary corporations, and that they are organized and operated for the purpose of making profit. It has been argued that it therefore follows that cooperatives should pay taxes on the same basis as other corporations.

In reply to the assertion that farm cooperatives both need the encouragement and deserve the assistance now granted them in the form of tax exemption, it has been pointed out that, since the exemption was originally granted, these organizations have developed greatly in financial strength and economic importance. Moreover, reference has been made to the fact that the Farm Credit Administration through its

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1/ The only legislative reference to the reasons for exemption of cooperatives (in the Ways and Means Committee Report on the Revenue Act of 1916) states that specific exemption of cooperatives and certain other associations was deemed advisable because the experience of the Treasury prior to that time had been "that the securing of returns from them has been a source of expense and annoyance and has resulted in the collection either of no tax or in an amount which is practically negligible."

Banks for Cooperatives and its research facilities is already giving cooperatives important assistance. Finally, it has been argued that, if any further assistance is needed, it should be given in some form other than tax exemption, the benefits of which accrue largely to the successful and well-established organizations and not to those which need assistance most. Weak organizations in financial difficulty and new organizations having difficulty in gaining a foothold derive little advantage from tax exemption.

Exception has also been taken to the argument that repeal of the exemption would not result in sufficient additional revenue to justify the expense and trouble of its collection. It has been pointed out that most tax-exempt organizations, including cooperatives, are now required to file annual information returns (Form 990), and that the recent tabulation of these returns by the Bureau of Internal Revenue shows that, while the revenue involved may be small in relation to total Federal revenue, it is not negligible. It is roughly estimated that for 1943, the 5,600 exempt cooperatives, in the absence of the exemption, would have paid between $10 million and $20 million in taxes on earnings devoted to dividends on stock and reserves. 1/ It is said to be unlikely that the processing of an additional 5,600 returns by the Bureau would have absorbed any significant part of this additional revenue.

1/ The total dividends on stock reported by the 5,223 farm cooperatives for which items of receipts and disbursements were tabulated were about $11.7 million. This total is a maximum, however, since it overstates the tax base to an undetermined extent because of intercooperative dividends and because some dividends could be converted to interest by cooperatives. A fair minimum estimate would probably be about $7 million. There was no item on the Form 990 for reserves, but most additions to reserves appear either under "other disbursements or charges," or in the difference between total receipts and total disbursements. The combined total of these items was about $35 million, but unquestionably many other non-reserve items are included, possibly even to the extent of 50 percent. Moreover, if the exemption were removed, it is probable that many cooperatives would accumulate the greater portion of their funds by use of non-cash patronage dividends instead of reserves. The maximum potential base is, therefore, about $47 million and the minimum about $25 million.

2. Controversial issues raised by the proposal to repeal the exemption

An important controversial issue raised by the proposal to repeal the exemption is whether farm cooperative associations perform services of such great value to the public that they should be relieved of the tax burdens imposed on other corporate entities. This is not an easy issue to resolve. Farm cooperatives, even though they are operated primarily in the interest of their farmer-patrons, undoubtedly have contributed to the general welfare. On the other hand, there are few businesses which could not make some claim to having served public as well as private interests. As has been pointed out elsewhere, cooperatives and ordinary corporations each provide a means whereby individuals, in earning their living, may satisfy their own particular hopes and aspirations, and experience alone can determine the fields in which each can most usefully make its own peculiar contribution to the economy. 1/

It must be recognized that there is always a presumption against any tax exemption and in favor of uniform taxation. An exemption can be justified only by a clear preponderance of evidence in favor of the social desirability of the objective and the effectiveness of the exemption in promoting desirable ends without undesirable collateral effects. In deciding whether the exemption should be repealed or retained considerations of revenue and equity must be weighed against the advantages to the economy as a whole which result from this particular form of encouragement to the flow of capital and effort into cooperative associations.

So long as patronage dividends continue to be excluded from the income of cooperatives, it does not appear that the cooperatives themselves would be greatly harmed by the loss of their tax-exempt status. In fact, there are many within the cooperative movement who think that it creates an anamaly to have agricultural cooperatives tax-exempt and other cooperatives not so favored. They are inclined to question whether the exemption is in the best interest of the movement, since the restrictions on business done with non-farmers limit expansion of cooperation in urban areas. On the other hand, repeal of the exemption alone would in no sense satisfy those who believe that farm cooperatives should be taxed like ordinary businesses. They seek repeal of the exemption as a matter of course, but their major objective is the termination of the patronage-dividend exclusion.

1/ Report of the Royal Commission on Cooperatives, Ottawa, 1945, p. 31

3. Alternative proposals short of full repeal

The suggestion has been made that if the exemption is not repealed, it should at least be confined to the "grass-roots" cooperatives whose problems led to the original enactment by Congress. This suggestion raises difficult problems in connection with determination of eligibility for exemption. The definition of a "small" cooperative is a matter of judgment, and any statutory or administrative definition would have to be essentially arbitrary. Moreover, particular cooperatives might move in and out of the exempt area because of year-to-year fluctuations in business or membership. Large associations might be split up to take advantage of the exemption. Other associations would be able to maintain their exempt status (if the exemption were limited in terms of size of gross receipts) by changing to a commission basis and not taking title to patrons' product.

The suggestion has also been made that if the exemption is retained ambiguities in the present statute should be cleared up. For example, the statute is silent about manufacturing operations by exempt cooperatives. It offers no solution to the question of income from by-products. It provides no real clue as to what are "reasonable and necessary reserves." It has been pointed out that the Bureau of Internal Revenue has been forced to make interpretations of the intent of Congress with respect to these and other matters without specific guidance from the statute. As a result, there has been a considerable amount of litigation with respect to qualification for the exemption.

C. Require the inclusion of all patronage dividends in the income of cooperatives

1. Summary of arguments for and against the present exclusion of patronage dividends from the income of cooperatives

The exclusion of patronage dividends from the gross income of cooperatives has been defended on three main grounds. First, it has been argued that these payments are in the nature of price rebates and as such are not income within the meaning of the Sixteenth Amendment. Second, it has been argued that a farm cooperative is essentially a partnership of farmers with the association acting in the role of agent and having no interest in the net proceeds of the business. Finally, it has been contended that, even if patronage dividends were held to be legally taxable to the cooperative association, they should not be so taxed because it is virtually impossible to determine to what extent these payments represent distributions of profits and to what extent they do not.

The principal argument against the exclusion is the contention that there is no difference between the patronage dividends of cooperative associations and the ordinary dividends of commercial corporations. It is argued that the fact that these dividends are paid to patrons, who are also stockholders, rather than to stockholders as such does not affect their character as a distribution of profits. Patronage dividends not contractually fixed as to amount at the time of sale, it is said, are not true rebates. Neither, it is said, can an association which pays dividends on capital stock and accumulates reserves be regarded merely as the legal agent for its members. Patronage dividends, it has been argued, are the property of the association acting as a principal and as such should be taxed in the same manner as ordinary dividends. While it is usually admitted that not all so-called patronage dividends are analogous to ordinary dividends, it is argued that patronage dividends can be administratively separated into their constituent elements.

2. Controversial issues raised by the proposal to include patronage dividends in the gross income of farm cooperatives

Since the exclusion of patronage dividends from the gross income of farm cooperative associations virtually exempts most of these associations from income tax, the proposal to include these payments in the tax base raises the same general policy issue as is raised by the proposal to repeal the exemption: namely, should farm cooperatives as a matter of public policy be granted more favorable tax treatment than ordinary corporations. But in addition, the proposal to discontinue the exclusion of patronage dividends raises a number of issues, which would still have to be resolved if it were decided that all of the income earned by cooperatives should be taxed to the associations as such. These issues relate, first, to the power of Congress to tax patronage dividends and, second, to the propriety of using patronage dividends as a base for assessment of income tax. The first question is primarily one of the constitutionality of a tax on payments made to patrons in accordance with a pre-existing contract. The second concerns the concept and measurement of net income.

a. Are patronage dividends taxable income to the cooperative?

Because of the Treasury's practice of permitting patronage dividends to be excluded from gross income by cooperatives (and other businesses) the issue of whether such dividends may constitutionally be included in gross income has not been squarely presented to the courts. In the cases in which the courts have been called upon to determine whether the exclusion should be denied, the position of the Treasury has been that the dividends paid were not true patronage dividends, generally on the ground that they were paid only to members or stockholders.

Several arguments have been advanced in justification of the present practice of permitting the exclusion from gross income of all amounts paid as patronage dividends. One argument is that such dividends constitute discounts or rebates. The rebate or discount increases the cost of goods purchased by the association or decreases the price of goods sold by the association. By the same token, it increases the price received by the patron for goods sold by him to or through the association, or reduces the cost to the patron of goods purchased by him or through the association. Thus in Uniform Printing and Supply Company v. Commissioner, 1/ the taxpayer, a corporation all of whose stock was owned by a group of insurance companies who were its sole customers, was required by its by-laws to return to its customers, in proportion to business furnished by them, the surplus earnings not in the opinion of the board of directors required in the conduct or expansion of the business. The determination of the Commissioner that amounts so returned were dividends to stockholding customers was upheld by the Tax Court. In reversing this decision, the Circuit Court held that the payments were customer rebates similar to discounts. Similarly, in Midland Cooperative Wholesale, 2/ the Tax Court stated that the justification for allowing the exclusion rested on the fact that patronage dividends are in reality rebates upon the business transacted by the association with its members rather than true income to the cooperative.

Another line of argument is that patronage dividends cannot be considered income to the association, since they are at all times the property of the patrons. The association, it has been argued, is merely the agent of the patrons and holds any excess remaining after payment of expenses as bailee for the patrons and is legally obligated to return such excess to them. It has also been urged that an association which agrees to distribute all its earnings to the patrons cannot be considered an entity apart from the patrons. The association is in fact the patrons acting in concert. Like a partnership, it is merely the alter ego of the patrons. Accordingly, it has been argued that the association as such cannot have any profits and that any income which is obtained is income of the patrons.

Others contend that patronage dividends are not essentially different from dividends paid on capital stock. They maintain that although patronage dividends may be described as rebates, such rebates are paid to patrons whose interests the association is seeking to further, rather than to persons with whom the association deals at arm's length. The payment of such rebates, it has been argued, constitutes a distribution of profits to the real owners of the association just as the payment of dividends on capital stock represents a distribution of income to the real owners of a corporation.

1/ 88 F. (2d) 75 (C.C.A. 7th, 1934).
2/ 44 BTA 824 (1941).

Those who argue for the inclusion of patronage dividends also deny that the funds from which such dividends are paid are at all times held by the association merely as agent. 1/ They point out that despite the obligation of the association to return to its patrons all net proceeds, the association has the power to divert some of its receipts to the payment of dividends on capital stock and to the establishment of reserves. They cite these powers as evidence that the association, rather than the patrons, is the owner of the funds from which patronage dividends are paid. 2/ It has also been pointed out that an ordinary corporation does not eliminate its taxable income by entering into a binding contract governing the disposition of its net income.

Enough has been said to indicate the nature of the court decisions relied upon by those who take positions on either side of the constitutional issue. The discussion now turns to the major policy issue of whether Congress should attempt to include patronage dividends in the gross income of the association and thereby specifically present the constitutional issue to the courts.

b. Do patronage dividends provide an appropriate base for the assessment of income tax?

The question discussed in this section is whether patronage dividends provide an appropriate base for the assessment of income tax on the cooperative association as such. The approach is to consider to what extent the amounts which farm cooperative associations report as patronage dividends are analogous to the earnings and profits of ordinary corporations.

From the previous discussion of the way cooperatives operate, it seems clear that these associations give rise to economic income over a period of years, at least to the extent that they use any substantial amount of capital and assume any significant degree of risk. The economic income earned by cooperatives, however, cannot be satisfactorily measured by the amount of patronage dividends distributed. Some cooperatives so conduct their business that no patronage dividends are needed to return their benefits to patrons. In other cases, patronage dividends either understate or overstate the amount of economic income earned by the association. In still other cases, so-called patronage dividends are paid by associations that are not engaged in operating a business in the ordinary sense.

1/ In this connection they cite the case of Farmers' Union Cooperative Company of Guido Rock v. Commissioner, 90 F. (2d) 488 (C.C.A. 8th, 1937).
2/ Other decisions which have been cited as indicating that the courts are not always responsive to the agency and rebate arguements in their application to cooperatives include Juneau Dairies, Inc., 44 B.T.A. 79 (1941) and Maryland and Virginia Milk Producers' Association v. District of Columbia, 119 F. (2d) 787. Discussion of these and other cases would not, however, throw much additional light on the constitutional question at issue.

One type of case in which cooperative associations do not pay patronage dividends is that in which their business is operated on a cost-plus-expenses basis, with benefits returned to patrons currently in the form of higher (or lower) prices for goods marketed (or purchased). At the present time, a much more important type of case is that in which marketing associations make only a token payment to the farmer at the time they accept delivery of his product and pay him the balance of the proceeds of sale at the close of the marketing season. These associations do not ordinarily keep their accounts so as to make possible a separation of those elements which an ordinary corporation would consider its cost of goods sold from those elements which it would consider its profits. 1/

Among those cooperatives which regularly pay patronage dividends, the amounts paid may either overstate or understate the economic income earned by the association. For example, purchasing associations sometimes make a practice of charging the farmer somewhat more than the market price in order to accumulate capital. The extra amounts are returned to patrons in the form of non-cash patronage dividends, but they are actually a form of capital contribution of members rather than income earned by the association. Understatement of the economic income of the association may result where the cooperative sells at a price below the market but high enough to result in a small patronage dividend at the end of the year.

Even among cooperatives of the Rochdale type whose avowed objective is to pay (or charge) prevailing prices, patronage dividends do not necessarily consist solely of income earned by the association. If other competing businesses give special concessions which do not enter into list prices, such as quantity or seasonal discounts, free delivery, or the extension of credit, the cooperative may choose to match these, not by offering the same services, but by holding out the prospect of a patronage dividend at the end of the year. To the extent that the patronage dividend does substitute for "quality" or non-price competition, it will, of course, exceed the amount which would be analogous to the profits of an ordinary corporation.

1/ These cooperatives occasionally refer to the entire final payments as "patronage dividends", but the payments are clearly not analogous to patronage dividends in the ordinary sense.

Finally, some associations that distribute so-called patronage dividends are not engaged in business activities in the ordinary sense and hence can hardly be said to earn business income, although they may benefit farmers. In such cases, the patronage-dividend device is merely a method of adjusting preliminary assessments for expenses to actual expenses. For example, some marketing associations are essentially bargaining associations, which negotiate prices with buyers and leave the actual sales to farmer-members. These associations often levy a tentative assessment on each unit of produce to cover expenses of the association. If actual expenses prove to be less than the assessment, the excess is returned to members in the form of a "patronage dividend" in proportion to products sold by each individual member.

It appears, therefore, that there are substantial grounds for questioning the appropriateness of patronage dividends as a base for taxing the income earned by cooperatives. In many situations, a statute requiring the inclusion of patronage dividends in the gross income of cooperative associations would operate most inequitably. It would result in overtaxation of cooperatives in cases where patronage dividends overstate the economic income earned by the cooperatives. It would result in unfair discrimination among different types of cooperatives in cases where patronage dividends understate the economic income earned by the cooperatives, or where patronage dividends are not used at all. It would not be an effective means of equalizing taxes on cooperatives and other forms of business organizations.

Moreover, if patronage dividends were included in the gross income of cooperatives, the result might merely be to induce those associations which now report substantial patronage dividends to change their methods of doing business so as to have little or no net proceeds to distribute at the close of the year. In the case of an ordinary corporation it is always in the interest of the firm to maximize its net income, regardless of the fact that the income is subject to the corporation income tax. But the situation with respect to the cooperative association is quite different. The primary objective of a farm cooperative is not to maximize the income shown on its own accounting statements but to maximize the income of its farmer-members. Success in achieving this objective is not dependent on the size of patronage dividends. In the case of a marketing association, a low initial price and a large patronage dividend are equivalent, from the standpoint of the farmer, to a higher initial price and a smaller patronage dividend. In the case of a purchasing association, a high initial price and a large patronage dividend are equivalent to a lower initial price and a smaller patronage dividend. Although those cooperatives now using the patronage-dividend device undoubtedly find it convenient, inclusion of patronage dividends in the gross income of cooperatives would greatly lessen the attractiveness of this device. The tax could be, and in many cases probably would be, avoided by direct price adjustments and other devices now used by many cooperatives which return benefits to patrons without the use of patronage dividends.

The possibility that patronage dividends might understate the income earned by cooperatives, or might not be used at all, has not been overlooked by those who favor the inclusion of these payments in the gross income of cooperatives for tax purposes. To meet this problem, they would require the Bureau of Internal Revenue to reconstruct the income of cooperatives and to determine what patronage dividends would have been paid had the association paid (or charged) prevailing prices minus (or plus) reasonable operating expenses. They assert that income of cooperatives could be reconstructed by reference to prevailing market prices, where available or by comparison with comparable firms. On this approach, income tax would be assessed on the basis of the reconstructed income, including reconstructed patronage dividends.

Such a plan would, it is clear, raise a host of administrative problems. 1/ The Treasury would have to determine prevailing prices for a large number of commodities in every local market for every day in the year. It would be extremely difficult to determine to what extent commodities handled and services rendered by cooperatives and ordinary firms were actually comparable. The assessment of tax would require an elaborate and time-consuming process, and would doubtless give rise to much litigation. It should be noted that, if such a plan were adopted for farm cooperatives, consistency would require its extension to non-farm cooperatives, including the many cooperative procurement associations used by retailers and other businessmen. The administrative problems would, therefore, be even greater than may appear at first glance.

Even if administrative problems connected with the reconstruction of income of cooperatives could be satisfactorily met, the plan would raise a fundamental issue of tax equity. In the case of cooperatives, price policies, which may have been chosen for non-tax reasons, would, in effect, be disregarded in the determination of tax liability. This raises the question whether it would be fair to tax cooperatives on the basis of some concept of "normal" income--a concept which would inevitably be subject to many different interpretations--without doing the same in the case of other businesses.

1/ These administrative problems would be essentially similar to those encountered in auditing claims for refunds of processing taxes after these taxes were declared unconstitutional and in administering section 722 of the Internal Revenue Code, which involves reconstruction of base-period income of taxpayers in connection with claims for relief under the excess-profits tax. These problems required an enormous investment of time by revenue agents and the creation of special divisions within the Bureau of Internal Revenue to expedite settlements. It should be noted that in the case of the processing taxes and the excess-profits tax the problems were non-recurrent and that large amounts of revenue were involved.

D. Continue the exclusion of cash patronage dividends but require the inclusion of non-cash patronage dividends in the income of cooperatives

Some recommend that the exclusion of cash patronage dividends be continued but that cooperative associations be required to include in their gross income patronage dividends paid in scrip or other non-cash forms. As was pointed out earlier in this report, non-cash patronage dividends by farm cooperatives have been regarded as the equivalent of cash distributions on the grounds that they are in effect cash payments automatically reinvested under the provisions of the charter, by-laws, or other contracts previously agreed to by the patrons. Accordingly, it has been held that they are taxable to the individual patron rather than to the association. Many of the problems and issues relating to the proposal to include all patronage dividends in the income of cooperatives, which are discussed in the preceding section, are pertinent to the proposal to include non-cash patronage dividends in the income of the associations. This section, however, deals only with the special problems and issues raised by the proposal to include non-cash patronage dividends in the income of the cooperatives, while continuing the exclusion of cash patronage dividends.

1. Summary of arguments for and against the present treatment of non-cash patronage dividends

The present treatment of non-cash patronage dividends is similar to the treatment of earnings reinvested in a partnership. This partnership approach has been criticized as being unrealistic with respect to the great majority of farm cooperatives. With the integration and consolidation of these associations into inter-regional organizations the individual farmer has been said to be too far removed from the activities and control of the overhead organization to be treated as a partner. It has also been argued that many patrons of farm cooperatives do not have any real choice regarding the form in which they will receive their patronage dividends. Both non-member patrons and dissenting minority members are, it is pointed out, bound by the vote of the majority members, which is said to vitiate the contention that non-cash patronage dividends are voluntary contributions of capital. It has been contended that in many cases the farmer either receives only a book credit or a non-transferable certificate and so has nothing that can be regarded as a true rebate. Furthermore, it has been argued that the farmer does not regard his scrip dividend as the equivalent of cash and, therefore, does not report it in his income tax return and that, in actual practice, the partnership approach is not always followed.

On the other hand, those who favor the exclusion of non-cash as well as cash patronage dividends argue that the members of cooperatives typically play an active part in determining the policies of their associations. It has, therefore, been contended that it is appropriate to make members accountable for individual income taxes on earnings, which the members have voted to reinvest in the association. As regards the fairness of taxing such dividends in the hands of non-member patrons and dissenting minority members, it has been argued that no farmer is obliged to trade with, or become a member of, a cooperative association. Consequently, it is said, if he decides to deal with or to join a cooperative in order to share in its benefits, he should expect to assume any obligations which the members as a whole decide to impose on themselves. To permit every patron to exercise his own individual choice in the matter would, it is said, invite "free riding" and possibly undermine the economic foundations of the organizations themselves. As to whether a non-cash patronage dividend can be regarded as a true rebate, it has been argued that the question of its transferability or liquidity is essentially irrelevant. The farmer receiving an interest-bearing or dividend-paying security has a claim on future income which it is said any reasonable man would include in his personal balance sheet, irrespective of its liquidity. Finally, as regards the matter of reporting such receipts, it has been held that the problem could be easily handled, first, by making the farmer more aware of the tax status of these payments and, second, by requiring the associations themselves to provide information at the source.

2. Other considerations raised by the proposal to include non-cash patronage dividends in the income of cooperatives

The proposal to require the inclusion of non-cash patronage dividends in the income of cooperatives raises the problem of the definition of cash and noncash distributions, in the light of the doctrine of constructive receipt of cash. This is a highly technical matter, which would ultimately have to be passed on by the courts. In the few decisions on the matter, the lower courts have been disposed to consider as equivalent to cash both (a) options to receive cash in lieu of stock and (b) patronage dividends applied to the purchase of stock by members in accordance with the by-laws of the association. 1/

1/ Midland Cooperative Wholesale, 44 BTA, 824 (1921); United Cooperative, Incorporated, 4 T.C. 93.(1944).

Even if Congress were willing to adopt a more restrictive definition of a "cash" distribution than the courts have thus far been disposed to follow, it seems highly likely that the courts would continue to hold that an option to receive cash is equivalent to actual receipt of cash. Many cooperatives already make a practice of giving patrons an option to receive patronage dividends in the form of stock or cash. Their success with this practice makes it probable that its use would increase among cooperatives whose distributions might not otherwise qualify for the exclusion as cash patronage dividends.

Congress could presumably provide by statute that distributions of stock or book credits shall not be considered the equivalent of a cash patronage dividend unless the stock or book credit is transferable. At the present time, the majority of cooperatives using revolving funds and paying non-cash patronage dividends do not issue any actual certificates, and, among those associations issuing certificates, many use non-transferable stock. 1/ If, however, non-transferable distributions were made taxable, there would appear to be no important legal or economic reasons for any cooperative to continue to issue non-transferable paper (except possibly in the case of non-stock association members' certificates). The principal function of non-transferability has been to prevent speculation in the paper of new organizations--a factor which would be of only minor significance relative to the tax.

In the light of the foregoing considerations, it appears that a requirement that non-cash distributions of patronage dividends be included in the income of cooperative associations, while cash distributions were excluded, would not prevent cooperatives from building up substantial amounts of capital out of earnings not taxed to the association. By use of the option to receive cash and perhaps also by the distribution of transferable stock, cooperatives could retain income which would be regarded as constructively received by members and hence excludable from the taxable income of the association. Moreover, it would be possible for cooperatives to levy assessments against patrons to distribute cash patronage dividends and at the same time to levy an equivalent assessment against patrons. This would enable the association to qualify for the exclusion, while still, in effect, accumulating capital out of earnings.

1/ Among the organizations which do issue certificates, an informed estimate is that about one-fourth of the certificates are in the form of preferred stock (all transferable) and most of the remainder is in the form of revolving-fund or other certificates (about one-half of which are transferable). Patronage dividends in the form of common stock (particularly important in the case of non-member patrons) are generally legally transferable, although in most cases the stock must be offered at least at first to other members or to the association itself.

E. Alternatives to the income tax as a method of taxing farm cooperatives

The difficulties that would be encountered in attempting to include patronage dividends of farm cooperatives in the corporation income tax base have persuaded some critics of the present treatment that some other approach must be used to tax these associations to the same extent as ordinary business corporations. The present disparity in the tax burdens of cooperatives and ordinary corporations should, in their opinion, not be permitted to continue. If tax equality cannot be achieved under the income tax, it is their view that it should be approached from some other direction. Two alternative taxes have been suggested, each of which will be given brief consideration.

1. Gross receipts tax

An alternative to a net income tax on farm cooperatives that has been suggested is a tax based on gross sales or receipts. In the view of its sponsors, such a tax would have the advantage of reducing the effect of variations in accounting methods on cooperative tax liability. Although the association doing business on the prevailing-price method would still be somewhat more heavily taxed than one operating on a cost-plus-estimated-expenses basis, the difference would be much less than it would be under a net income tax with patronage dividends included in gross income.

It would, however, be impossible to select any one rate of tax on gross sales or receipts which would be approximately equivalent to the corporate income tax if imposed on the economic income of cooperatives. The amount of profits earned on a dollar of gross sales or receipts varies widely from industry to industry, and to a lesser extent from firm to firm in the same industry. It depends on such factors as the amount of capital employed and its rate of turnover and whether the particular firm is a producer of basic commodities, a processor, a wholesaler, or a retailer. Even though farm cooperatives, taken as a whole, are predominately trading associations, it appears that a tax on gross sales or receipts would probably yield rather capricious results. Among ordinary corporations, a uniform tax on gross sales or receipts would be equivalent to widely different rates on net income as between manufacturers, wholesale trade, and retail trade, and as between retailers in different lines. 1/

1/ For example, in 1942, a 1-percent tax on gross sales and receipts from operations would have been equivalent to the following percentages of compiled net profits of corporations filing income tax returns (including those with and those without net income): total manufacturing, 8.6 percent; wholesale commission merchants, 15.6 percent; other wholesalers, 26.3 percent; retail trade, general merchandise, 11.2 percent; retail food stores, including market milk dealers, 50.0 percent; filling stations, 29.4 percent; retail hardware stores, 16.7 percent; retail building material, fuel, and ice stores, 25.6 percent. Computed from Statistics of Income for 1942, Part 2, Table 3.

There is every reason to believe that the same would be true of a uniform gross-receipts tax on cooperative associations of different types. A further complication arises from the fact that the income tax on ordinary corporations is not imposed at a uniform rate but is graduated on net incomes of less than $50,000.

Under a gross-receipts tax, additional differences in taxes on essentially similar cooperative associations would arise out of purely legal differences in the form of organization and method of doing business. For example, a federated cooperative (composed of a number of legally independent units) would presumably be subject to tax each time products moved between successive stages, whereas only one tax would be imposed in the case of a centralized association. Moreover, marketing and purchasing associations which operate on a commission basis, without taking title to the goods handled, would presumably be subject to tax only on their gross receipts from commissions, whereas otherwise similar associations, which, however, take title to the goods handled, would be taxed on a much larger base. Imposition of the gross-receipts tax would doubtless stimulate changes in legal organization and method of doing business intended to minimize the tax.

Any attempt to meet these problems by establishing different rates of tax for different types of associations would encounter formidable difficulties and would still leave the equity problem unsolved in borderline cases.

Finally, it is generally agreed that a gross-receipts tax is much more likely to be passed on to consumers than is a tax on net income. To the extent that the tax was passed on in the form of higher prices for farm products, it would, of course, fail to accomplish its primary objective of imposing a tax on the economic income of the cooperative associations. The possibility of shifting of a gross-receipts tax would be greatest in cases where cooperative marketing associations supply a large share of the market for a particular commodity.

2. Tax on invested capital

A second alternative, or supplement, to a net income tax that has been proposed is a tax based on invested capital. A tax of this type would be based on the presumption that the capital invested in a cooperative association may be expected to earn at least a normal rate of return for its owners.

The imposition of such a tax would raise the problem of defining invested capital, particularly that of determining whether it should include only equity capital or both equity and borrowed capital. In favor of confining the tax to equity capital, it has been pointed out that ordinary corporations are allowed a deduction for interest paid on borrowed capital and hence argued that, if the objective is to impose a tax equivalent to the income tax on ordinary corporations, cooperatives

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should be allowed to exclude borrowed capital. Furthermore, it has been contended that the inclusion of borrowed capital would give an advantage to strong cooperatives that can borrow at interest rates lower than the average return on total invested capital. On the other hand, the inclusion of borrowed capital has been supported by the contention that in the case of cooperatives the distinction between equity and debt is not particularly significant, inasmuch as dividends on stock are strictly limited. Moreover, cooperatives pay non-cash patronage dividends in both debt and equity forms, and exclusion of debt would permit the associations to avoid the tax by distributing future non-cash patronage dividends in the form of debt obligations.

A further problem in connection with a tax on invested capital would be the selection of an appropriate rate. As in the case of gross receipts, there are important variations in the relation between invested capital and net income at any given time. Experience under the excess-profits tax has demonstrated that these variations are very large in the case of ordinary corporations, and it is reasonable to assume that the same lack of uniformity exists in the case of cooperatives. It may be presumed that all cooperatives that stay in business earn at least a normal rate of return over the long run, but year-to-year fluctuations above and below normal earnings are probably so wide that a tax assessed on an annual basis would often result in serious hardships or inequities. The tax on invested capital would bear relatively heavily on weak and declining associations but relatively lightly on strong and growing associations.

Finally, it may be pointed out that a tax on invested capital would give rise to serious legal and administrative problems. As experience under the excess-profits tax has shown, the valuation of invested capital is always a complex problem which is impossible to solve in an entirely satisfactory manner.

$R - C = I$

$R + D - C = I + D$

$R - (C - D) = I + D$

APPENDIX A

Economic Importance and Present Tax Treatment of Cooperatives Other Than Farmers' Marketing and Purchasing Associations

I. Urban purchasing cooperatives

Closest to the farmers' marketing and purchasing associations in terms of economic functions are the urban purchasing associations. These organizations differ from farm purchasing cooperatives only in the character of their membership and to some extent in the type of commodities handled. Many of these local urban associations are affiliated with the farmers' cooperatives in the regional and interregional federations (particularly, the petroleum associations).

As of 1945, the Bureau of Labor Statistics estimates that about 2,650 non-farm local purchasing associations 1/ were in existence with about 812,000 members. 2/ Retail grocery and other retail stores accounted for the bulk of the associations (1,850) and members (600,000), followed by petroleum associations (775 associations with 200,000 members). Total volume of business was estimated at nearly $330 million or about 6 percent of the total farm marketing and purchasing volume and about 33 percent of farm purchasing volume alone. Retail store sales were $171 million and petroleum sales nearly $140 million. No data are available as to the amount of patronage dividends paid by these associations, but the total was certainly less than $5 million and probably less than $2 million.

The tax status of these urban associations is the same as that of non-exempt farm associations. The associations are subject to the corporation income tax, but may exclude from gross income bona fide patronage dividends paid in cash as well as in non-cash form. Taxable income consists, therefore, of dividends paid on capital stock plus amounts retained and added to reserves.

Patrons of urban associations are not taxable on patronage dividends received. It will be remembered that patronage dividends to farmers from purchasing associations enter into income only indirectly (i.e., by reducing farm costs) since patronage dividends are held to be legally price reductions. A price reduction or "bargain purchase" as such is not considered taxable income and since consumers' expenditures for food, clothing, and the like are also not allowable deductions (i.e., costs of earning income) under present concepts of taxable

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II. Other cooperatives

Other types of organizations commonly considered as cooperatives in the broad sense include certain mutual insurance companies, mutual irrigation companies, cooperative telephone companies, credit unions, and the like. Here again, the essential tax principles previously discussed are fully applicable despite surface differences in actual methods of operation and organization. Unlike the urban purchasing group, most of these miscellaneous organizations are specifically exempt under some subsection of section 101 of the Internal Revenue Code. Where the organization makes a payment to members or patrons analogous to the patronage dividends of marketing or purchasing associations, the tax treatment is approximately the same. That is, refunds to business units enter into taxable income directly or indirectly, but refunds to non-business units are not taxable. The following table shows the number, membership, business volume (where available) and tax status of the miscellaneous organizations considered as cooperatives in official statistical sources. The table does not include the many organizations formed on cooperative principles by business firms for the purpose of procurement, wholesaling, and the like, which are not included in the ordinary usage of the term "cooperative".

Table 1

Number, Membership, Volume of Business, and Tax Status of Miscellaneous Cooperative Associations

Type of association	Total number of associations (est.)	Number of members or participants (est.)	Volume of business (est.) ($000)	Tax Status 1/
Production and other farmers' cooperatives: 2/				
Mutual irrigation companies (1940)	4,356	148,294	$6,437 3/	Exempt under IRC, section 101(10).
Farmers' Home Administration—Financed service cooperatives (August 1945)	243	117,000	4/	Variously exempt and non-exempt depending on particular activities.
Dairy herd improvement associations (January 1946)	1,124	23,331	5/	Exempt under IRC, section 101(1) provided net income does not inure to the benefit of any member.
Dairy bull associations (January 1946)	165	2,154	5/	Same as above.
Cooperative dairy cattle artificial-breeding associations (January 1946)	336	73,293	5/	Same as above.
Grazing associations (1946)	32	1,504	4/	Exempt under IRC, section 101(10).
Farmers' Home Administration—Financed marketing and purchasing associations (August 1945)	791	128,000	4/	Same as ordinary farmers' marketing and purchasing associations.

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Dairy bull associations (January 1946)	165	2,154	5/	Same as above.
Cooperative dairy cattle artificial-breeding associations (January 1946)	336	73,293	5/	Same as above.
Grazing associations (1946)	32	1,504	4/	Exempt under IRC, section 101(10).
Farmers' Home Administration—Financed marketing and purchasing associations (August 1945)	791	128,000	4/	Same as ordinary farmers' marketing and purchasing associations.

(Continued)

Table 1

Number, Membership, Volume of Business, and Tax Status of Miscellaneous Cooperative Associations (Continued)

Type of association	Total number of associations (est.)	Number of members or participants (est.)	Volume of business (est.) ($000)	Tax Status 1/
Farm financing cooperatives: 2/				
National farm loan associations (June 30, 1946)	1,601	362,000	4/	Exempt under IRC, section 101(15).
Production credit associations (June 30, 1946)	505	390,748	$15,143 6/	Same as above.
Banks for cooperatives (June 30, 1946)	13	2,064,454	4,741 7/	Same as above.
Service associations: 8/				
Burial (1945)	42	37,000	306	Exempt under IRC, section 101(10), (3) or (11) depending upon method of operation.
Medical (1945)	75	151,000	4,000	Exempt under IRC, sections 101(6) and (16).
Other service (1945) 9/	485	181,000	7,050	Variously exempt and non-exempt depending on particular activities.

(Continued)

Table 1

Number, Membership, Volume of Business, and Tax Status of Miscellaneous Cooperative Associations (Continued)

Type of association	Total number of associations (est.)	Number of members or participants (est.)	Volume of business (est.) ($000)	Tax Status 1/
Other: 8/				
Electricity (1944)	850	1,149,700	$60,960	Exempt under IRC, section 101(10).
Telephone (1936)	5,000	330,000	5,485	Same as above.
Credit unions (1945)	8,882	2,838,034	15,000 10/	Exempt under IRC, sections 101(4) and (15).
Insurance (1945) 11/	2,000	10,550,000	4/ 12/	Taxable on entire investment income except for certain small farm mutuals exempt under IRC, section 101(11).

Treasury Department, Division of Tax Research

1/ Associations designated as tax-exempt must meet various requirements to qualify for the exemption, and some of the organizations included in the statistics may not have qualified for exemptions.
2/ Report of Farm Credit Association, 1945-1946, p. 120.
3/ Supplement to Statistics of Income for 1943, Part 2. Data are for 769 organizations filing Form 990 returns for 1943.
4/ Not available.
5/ All organizations exempt under section 101(1) as agricultural or horticultural (including county fairs, cattle improvement associations, etc.) reported total gross receipts of about $17 million for 1943. Supplement to Statistics of Income for 1943, Part 2.
6/ Gross earnings January 1 through December 31, 1945.
7/ Gross earnings July 1, 1945 through June 30, 1946.
8/ U.S. Department of Labor, Bureau of Labor Statistics, Bulletin 890.
9/ Includes housing, medical, food lockers, etc.

(Footnotes continued)

Table 1

Number, Membership, Volume of Business, and Tax Status of Miscellaneous Cooperative Associations

Footnotes (Concluded)

10/ Gross receipts for 1943 as reported in Supplement to Statistics of Income for 1943, Part 2.
11/ Includes mutual life, casualty, and automobile associations, which are classified by the Bureau of Labor Statistics as being: (1) operated in conjunction with a cooperative association, or (2) small, local organizations subject to effective local-membership control.
12/ Total premiums estimated as about $200 million.

Appendix B

Table 2

Farmers' Marketing and Purchasing Cooperative Associations 1/
in the United States, 1944-45 Marketing Season 2/

Type of association	Number of associations		Estimated membership 3/		Estimated business 4/	
	Number	Percent	Number (In thousands)	Percent	Value (In millions of dollars)	Percent
Marketing						
Cotton and products	530	5.2	268	5.9	$ 178	3.2
Dairy products	2,214	21.8	726	16.1	1,294	22.9
Fruits and vegetables	916	9.0	162	3.6	784	13.9
Grain, dry beans, rice	2,285	22.5	484	10.8	1,286	22.8
Livestock	661	6.5	695	15.4	730	12.9
Nuts	46	.5	47	1.0	200	3.5
Poultry and eggs	160	1.6	131	2.9	225	4.0
Tobacco	12	.1	122	2.7	27	.5
Wool and mohair	130	1.3	123	2.7	35	.6
Miscellaneous	446	4.4	140	3.1	76	1.3
Total marketing	7,400	72.9	2,896	64.2	$ 4,835 5/	85.6
Purchasing	2,750	27.1	1,610	35.8	810 5/	14.4
Total marketing and purchasing	10,150	100.0	4,506	100.0	$ 5,645	100.0

Treasury Department, Division of Tax Research

Source: U.S. Department of Agriculture, Farm Credit Administration, Cooperative Research and Service Division, mimeograph.

Footnotes on next page.

Appendix B

Table 2

Farmers' Marketing and Purchasing Cooperative Associations 1/
in the United States, 1944-45 Marketing Season 2/

Footnotes

1/ Includes independent local associations, federations, large-scale centralized associations, sales agencies, independent service-rendering associations, and subsidiaries whose businesses are distinct from those of the parent organizations.

2/ A marketing season includes the period during which the farm products of a specified year are moved into channels of trade. Marketing seasons overlap.

3/ Includes members, contract members and shareholders, but does not include patrons not in these categories.

4/ Includes the value of commodities for which associations render essential services either in marketing or purchasing and the value of commodities sold by associations whether on a commission or a brokerage basis, and also some intra-association transactions.

5/ After making adjustment for the purchasing business of marketing associations and the marketing business of purchasing associations, it is estimated that the total purchasing business was approximately $1,095 million and the total marketing, $4,550 million.

APPENDIX C

Relative Growth of Cooperative Marketing
and Purchasing Associations, 1935-1943

I. Relative growth in cooperative marketing

In the case of marketing, the relative growth on the part of cooperatives can be shown by comparing changes in an index of the volume of cooperative marketing with changes in an index of total farm cash receipts from marketing. Table 3 shows indexes of cooperative and of total marketing with the years 1935 to 1939 as a base. An index of relative growth of cooperative marketing, obtained by dividing the cooperative index by the corresponding total index, is shown in column (3). 1/ If cooperatives had maintained exactly the same share of the market in each year, this series would always have a value of 100. In years when the index of relative growth is greater than 100, cooperatives handled a larger share of the market than in 1935-39. In years when the index of relative growth is less than 100, cooperatives handled a smaller share of the market than in 1935-39.

On the basis of index of relative growth it appears that there has been no marked tendency in recent years for cooperative marketing associations to take over a larger share of the total marketing business at the farm level. 2/ From 1936 to 1941 the trend was slightly downward. In 1941, 1942, and 1943, moreover, cooperative marketing was actually less than in the base period and did not reach base period levels until 1944.

1/ The relative growth of cooperative marketing may also be measured by adjusting (deflating) the index of cooperative marketing by (1) changes in the prices of farm products and (2) changes in the physical volume of farm products marketed. Computations of this sort were made based on the published index of prices received by farmers and the index of agricultural production. Although the data have certain rather serious limitations for this use, it is significant that the results obtained were substantially similar to those obtained from adjusting by cash receipts.

2/ It is interesting to note that the Canadian Royal Commission investigating cooperatives came to the same conclusion with respect to the recent growth of Canadian marketing associations, see Report of the Royal Commission on Cooperatives, Ottawa, 1945, Appendix A. The Commission also studied the growth in terms of individual commodities and found some areas of increase and decrease. It was not possible to make a similar commodity-by-commodity analysis of American cooperative activity for this memorandum, however, because of insufficient data.

Table 3

Relative Growth of Cooperative Marketing, 1930-1944

(Base all indexes, 1935-39)

Year	(1) Index of cooperative farm marketing	(2) Index of total cash receipts from farm marketing	(3) Index of relative growth of cooperative marketing (Col. 1 ÷ Col.2)
1930	126	113	112
1931	100	80	125
1932	69	59	117
1933	70	67	104
1934	77	79	97
1935	88	89	99
1936	108	105	103
1937	113	111	102
1938	97	96	101
1939	94	99	95
1940	105	105	100
1941	129	140	92
1942	174	192	91
1943	239	243	98
1944	262	248	106

Treasury Department, Division of Tax Research

Source: U.S. Department of Agriculture: Farm Credit Administration and Bureau of Agricultural Economics.

II. Relative growth of cooperative purchasing

Table 4 shows indexes of cooperative purchasing and of total farm expenditures on feed, fertilizer, and the operation of motor vehicles. Column (3) shows an index of relative growth of cooperative purchasing, obtained by dividing the cooperative index by the total index.

It is evident that there has been a substantial growth in the relative importance of cooperative farm purchasing since 1930. The most rapid relative growth occurred, however, during the period 1930-38, when tax rates were considerably lower than in later years. Since 1938, there has been no clear trend.

III. Sources of data and their limitations

The value of products marketed by cooperatives (valued at the farm level) is closely approximated by the series on the dollar volume of business of cooperatives computed by the Farm Credit Administration. This, however, is not altogether true in the case of processed products, which include the value of the raw product to the producer, together with handling and processing expenses. Limited amounts of service charges at terminal markets are included in some instances. The Farm Credit Administration estimates are based on financial statements and other reports from associations. Duplications resulting from interorganization turnover are eliminated in so far as possible. Inclusion of such handling and processing expenses, however, impairs the usefulness of the index only to the extent that there has been a significant change in the relative importance of these expenses. Total farm sale proceeds may be represented by the series on cash receipts from farm marketings, compiled by the Bureau of Agricultural Economics.

There are, however, certain limitations of these data when used for the purposes of measuring relative growth of cooperatives. In the first place, the results apply to cooperatives as a whole whereas ideally it would also be advisable to have data on the basis of individual commodities (and even on various regions so that any specific area of rapid growth or decline could be distinguished). In the second place, the two primary series are not strictly comparable. The cash marketing series reflects the influence of a number of commodities, notably hay, not handled to any extent by cooperatives. Moreover, the bulk of cooperative marketing is concentrated in a relatively few commodities, some of which are less heavily weighted proportionately in the cash receipts index. Nevertheless, for a study such as this one, where the interest is primarily in broad trends, it is believed that sufficiently reliable results can be obtained.

INTENTIONAL SECOND EXPOSURE

Table 3

Relative Growth of Cooperative Marketing, 1930-1944

(Base all indexes, 1935-39)

Year	(1) Index of cooperative farm marketing	(2) Index of total cash receipts from farm marketing	(3) Index of relative growth of cooperative marketing (Col. 1 ÷ Col.2)
1930	126	113	112
1931	100	80	125
1932	69	59	117
1933	70	67	104
1934	77	79	97
1935	88	89	99
1936	108	105	103
1937	113	111	102
1938	97	96	101
1939	94	99	95
1940	105	105	100
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Table 4

Relative Growth of Cooperative Purchasing, 1930-1944

(Base all indexes, 1935-39)

Year	(1) Index of cooperative farm purchasing	(2) Index of farm expenditures on feed, fertilizer, and operation of motor vehicles 1/	(3) Index of relative growth of cooperative purchasing (Col. 1 ÷ Col. 2)
1930	56	114	49
1931	47	77	61
1932	37	62	60
1933	39	67	58
1934	48	80	60
1935	82	82	100
1936	81	102	79
1937	114	113	101
1938	108	94	115
1939	116	109	106
1940	117	119	98
1941	155	145	107
1942	194	187	104
1943	262	241	109
1944	284	244	116

Treasury Department, Division of Tax Research

Source: U.S. Department of Agriculture: Farm Credit Administration and Bureau of Agricultural Economics

1/ Operation of motor vehicles includes expenditures for gasoline, oil, tires, and labor for repairing tractors, and gasoline, oil, tires, and replacement parts, labor for repairs, registration fees and insurances for automobiles and trucks. Only 40 percent of the total operating costs of automobiles is included as a production expense.

Another difficulty arises from the fact that the data compiled by the Farm Credit Administration are presented in terms of marketing seasons which spread over portions of two years, whereas the cash receipts totals are on a calendar year basis. For purposes of this appendix, the first year of a given marketing season has been taken as the link to the other series (i.e., marketing season 1943-44 corresponds to calendar year 1943). 1/

Measurement of the relative growth in cooperative purchasing at the farm level also involves certain difficulties. There is no series on the total volume of farm purchases. It is known, however, that the principal products handled by cooperatives are feed, fertilizer, and gasoline, oil and other automotive supplies. 2/ Annual totals of farm expenditures on these items are published by the Department of Agriculture.

While an index based on these totals is perhaps the best available, it obviously suffers from a very serious limitation, arising out of its implicit overweighting of feed and underweighting of gasoline, oil, etc., as compared with the index of cooperative purchasing. 3/ Since changes in the value of feed expenditures by farmers were substantial, the effect may be to understate any uptrend in the adjusted index. 4/

1/ There is less error in this procedure than in the opposite approach since about 90 percent of the returns submitted to the F.C.A. are on a calendar rather than fiscal year basis.

2/ In 1936, these products accounted for about 60 percent of total purchasing by all cooperatives (Statistical Handbook of Farmers' Cooperatives, p. 94). A study of 16 large regional cooperatives in 1944 showed that the proportion for these organizations was nearly 85 percent, but recent figures reflect wartime shortages of many other items customarily handled by cooperatives.

3/ Moreover, the data on expenditures for the operation of motor vehicles are not strictly comparable with cooperative purchase of motor vehicle supplies. The former includes such things as cost of registration, insurance expenses and labor for repairs. In addition, only 40 percent of the cost of operating automobiles is included.

4/ On the other hand, construction of an aggregate index for feed, gas and oil, and fertilizer with weights of 5, 3, and 1, respectively, and 4, 2, and 1, did not produce noticeably different results.

APPENDIX D

Recent Expansion of Cooperative Manufacturing

Estimates of the number and types of productive plants operated by farm cooperatives are shown in Tables 5 and 6 of this appendix.

It can be seen from Table 5 that marketing cooperatives operated about 2,800 plants in 1943, of which nearly three-fourths were engaged in processing milk into butter, cheese, and dry skim milk. With the exception of dry skim milk, this productive capacity is of long standing, and the proportion of butter and cheese manufactured cooperatively has not increased in recent years. In fact, it is of interest that during the war some of the large commercial cheese companies bought out many local cooperative cheese factories. It is also significant that studies have disclosed a trend in the dairy industry to larger scale units, a trend in which cooperatives have been lagging behind the rest of the industry. 1/

The only other areas where there are substantial number of cooperative plants processing farm products are in cotton ginning and canned fruits and vegetables. With respect to the former, it is to be noted that most of this expansion took place during the period 1930 to 1940. There was considerable expansion in cooperative canning during the war as a result of the tremendous demand for food and the efforts of the Government to increase the production of canned foods. Cooperatives appear to have handled increasing proportions in most products, but the proportion of the total pack handled by cooperatives is still very small. Only in canned berries, cherries, pears, and citrus fruit juices do cooperatives handle as much as 10 percent of the pack. In some of the most important canning products, such as peas, tomatoes, and corn, they account for only 1 to 3 percent of total production.

Table 6 shows the number of plants operated by farmers' purchasing cooperatives in 1943. The three numerically largest group of plants, grinding mills, oil wells, and repair shops, are, of course, not manufacturing operations in the strict sense of the term. Exclusive of these groups, the principal areas of cooperative manufacturing are fertilizer, feed, and petroleum refining and blending. This is to be expected, of course, since these items represent the principal operating expenses of farmers and since cash expenditures for these items by farmers have been increasing steadily in importance.

1/ D. E. Hirsch, Farmers' Cooperatives and the Trend Toward Large-Scale Dairy Plants, Department of Agriculture, Farm Credit Administration, Cooperative Research and Service Division, Miscellaneous Report No. 80.

Table 5

Cooperative Plants for Processing Farm Products
December 31, 1943

Type of plant	Number of plants	Percent of total cooperative product processing plants
1. Creameries	1,353	49%
2. Cheese factories	531	19
3. Cotton gins	407	15
4. Canneries, dehydrating plants (fruits and vegetables)	190	7
5. Dehydrating plants (milk)	172	6
6. Flour and cereal mills	18	1
7. Wineries	16	1
8. Sugar mills and honey plants	15	1
9. Nut processing and packaging plants	14	1
10. All other	44	2
Total	2,761	100%

Treasury Department, Division of Tax Research

Source: "Trends in Farmer Cooperation," News for Farmer Cooperatives (U.S. Department of Agriculture, Farm Credit Administration), February 1944.

INTENTIONAL SECOND EXPOSURE

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Total	2,761	100%

Treasury Department, Division of Tax Research

Source: "Trends in Farmer Cooperation," News for Farmer Cooperatives (U.S. Department of Agriculture, Farm Credit Administration), February 1944.

Table 6

Cooperative Plants for Farm Supply Requirements,
December 1, 1943

Type of plant	Number of plants	Percent of total cooperative farm supply plants
1. Farmers' elevators grinding feed	1,000	60%
2. Oil wells	350	21
3. Machine repair shops	100	6
4. Feed mills	57	3
5. Fertilizer plants	40	2
6. Seed cleaning plants	40	2
7. Chick hatcheries	32	2
8. Lubricating oil and grease compounding plants	11	1
9. Refineries	9	1
10. Sawmills	8	1
11. Farm machinery plants	7	*
12. Insecticide plants	6	*
13. Paint factories	5	*
14. Serum laboratories	4	*
Total	1,670	100%

Treasury Department, Division of Tax Research

Source: "Trends in Farmer Cooperation," News for Farmer Cooperatives (U.S. Department of Agriculture, Farm Credit Administration), February 1944, p. 4.

* Less than 0.5 percent

A study by the Farm Credit Administration of cooperative fertilizer production shows that cooperatives made important relative gains in the period 1938-1939 to 1942-1943. 1/ However, this study disclosed that the greatest relative advance was made between 1938-1939 and 1940-1941. The imposition of fertilizer controls in 1942-1943 drastically slowed the prewar expansion trend of cooperatives. Moreover, despite their substantial gains, cooperatives still accounted for only about 10 percent of total production. 2/

No comprehensive official studies have been made of cooperative activity in feed and petroleum refining. It is known, however, that the bulk of present feed capacity is of long standing, with most of present facilities constructed or acquired before the high-tax period. On the other hand, expansion of cooperatives into basic petroleum production refining is a recent development on the part of some regional cooperatives. Despite a very substantial growth, however, the value of refined petroleum products produced by cooperatives was still only about $20 million in 1944. 3/

On the basis of this brief summary of the extent of cooperative manufacturing, it is possible to draw certain conclusions with respect to the significance of these activities for tax policy toward cooperatives.

(1) The number of true manufacturing plants owned by cooperatives is still very small.

(2) Cooperative manufacturing is economically significant only in a very few areas; even in these fields (with the exception of dairy products) the production of cooperatives is small as compared to the total production and probably even with the total amount of production handled by cooperatives.

(3) A very substantial percentage of existing cooperative plants were built or acquired before the high tax period. All recent growth, therefore, must be considered as representing to some extent merely a continuation of normal trends. Moreover, some ground recently gained by cooperatives is attributable to purely wartime influences and may well be lost in the postwar period.

1/ Joseph G. Knapp, The Place of Cooperatives in the Fertilizer Industry (Preliminary Report), Department of Agriculture, Farm Credit Administration, Cooperative Research and Service Division, Miscellaneous Report No. 85.

2/ It is believed that further expansion in fertilizer may be anticipated because such a large proportion of all fertilizer used is consumed in the South, and this region historically has lagged behind the rest of the country in cooperative development.

3/ See "Operation of Consumers' Cooperatives in 1944," U.S. Department of Labor, Bureau of Labor Statistics, Bulletin No. 843, p. 16.

APPENDIX E

Distribution of Returns of Tax-Exempt Farmers' Cooperative Marketing and Purchasing Associations by Size of Gross Income and Receipts and by Size of Total Assets, 1943

This appendix shows available information on the size distribution of tax-exempt farmers' cooperative marketing and purchasing associations. It is based on tabulations of information from 4,397 returns of such organizations filed on Form 990 for the calendar year 1943 or for fiscal years beginning in 1943. These 4,397 returns include all returns received in the Bureau of Internal Revenue through December 31, 1944. They do not include the 1,198 returns of tax-exempt farmers' cooperative marketing and purchasing associations received in the Bureau of Internal Revenue between December 31, 1944 and September 1, 1945. Among these latter returns only those of organizations with total gross income and receipts in excess of $50,000 were tabulated by size groups, and they are not included in the tables in this appendix. Information drawn from the returns of tax-exempt farmers' cooperatives and other tax-exempt organizations was published by the Treasury Department, November 1, 1945, as a Supplement to Statistics of Income for 1943, Part 2.

Table 7 shows a distribution of 4,397 returns of tax-exempt farmers' cooperative marketing and purchasing associations by size of gross income and receipts for 1943.

Table 8 shows a distribution of the returns of 2,909 tax-exempt farmers' cooperative marketing and purchasing associations, which filed balance sheets, by size of total assets for 1943.

Tables 7 and 8 indicate that, although the great majority of tax-exempt farmers' cooperatives are comparatively small organizations, a large portion of the business done by tax-exempt cooperatives and of the assets held by such organizations is in the hands of the relatively few large organizations. A similar situation exists in the case of ordinary corporations.

In using the data presented in Tables 7 and 8, it should be remembered that it is impossible to say how complete their coverage is. Although it is believed that most organizations required to file an information return did so, it is not possible at this time to determine exactly how many cooperatives may have failed to file

a return for 1943. Furthermore, it is not certain how the distributions shown in Tables 7 and 8 would have been affected if it had been possible to include returns not received in the Bureau of Internal Revenue until after December 31, 1944. Finally, it is not known whether the size distribution of taxable farmers' cooperatives differs significantly from that of the tax-exempt organizations. It has not been possible to separate the tax returns of taxable farm cooperatives from those of ordinary corporations.

Table 7

Distribution of Returns of Tax-Exempt Farmers' Cooperative Marketing and Purchasing Associations by Size of Gross Income and Receipts, 1943

(Returns received in the Bureau of Internal Revenue through December 31, 1944)

Gross income and receipts classes	Number of returns			Gross income and receipts		
	Number	Percentage	Percentage cumulated	Amount (thousands)	Percentage	Percentage cumulated
Under $500	209	4.8	4.8	$ 43	*	*
$500 - 1,000	90	2.0	6.8	65	*	*
1,000 - 2,500	89	2.0	8.8	146	*	*
2,500 - 5,000	88	2.0	10.8	317	*	*
5,000 - 10,000	119	2.7	13.5	851	*	.1
10,000 - 15,000	90	2.0	15.5	1,094	*	.1
15,000 - 25,000	132	3.0	18.5	2,661	.1	.2
25,000 - 50,000	408	9.3	27.8	15,208	.7	.9
50,000 - 100,000	648	14.7	42.5	48,194	2.2	3.1
100,000 - 250,000	1,058	24.1	66.6	174,233	7.8	10.9
250,000 - 500,000	724	16.5	83.1	256,009	11.5	22.3
500,000 - 1,000,000	420	9.6	92.7	288,514	12.9	35.2
1,000,000 - 5,000,000	269	6.1	98.8	539,395	24.2	59.4
5,000,000 and over	53	1.2	100.0	907,173	40.6	100.0
Total	4,397	100.0		$2,233,904	100.0	

Treasury Department, Division of Tax Research

Source: Supplement to Statistics of Income for 1943, Part 2.

* Less than .05 percent.

Table 8

Distribution of Returns of Tax-Exempt Farmers' Cooperative Marketing and Purchasing Associations Filing Balance Sheets, by Asset Classes, 1943

(Returns received in the Bureau of Internal Revenue through December 31, 1944

Total assets classes	Number of returns			Total assets		
	Number	Percentage	Percentage cumulated	Amount (Thousands)	Percentage	Percentage cumulated
Under $1,000	67	2.3	2.3	$ 25	*	*
$1,000 - 5,000	126	4.3	6.6	348	.1	.1
5,000 - 10,000	122	4.2	10.8	933	.2	.3
10,000 - 15,000	166	5.7	16.5	2,104	.4	.7
15,000 - 25,000	401	13.8	30.3	8,021	1.6	2.3
25,000 - 50,000	811	27.9	58.2	29,509	6.0	8.4
50,000 - 100,000	601	20.7	78.9	41,334	8.6	16.9
100,000 - 250,000	381	13.1	92.0	58,294	11.9	28.8
250,000 - 500,000	103	3.5	95.5	34,328	7.0	35.9
500,000 - 1,000,000	64	2.2	97.7	45,688	9.3	45.2
1,000,000 - 5,000,000	51	1.8	99.5	104,871	21.4	66.7
5,000,000 - 10,000,000	9	0.3	99.8	66,002	13.5	80.1
10,000,000 - 50,000,000	7	0.2	100.0	97,087	19.9	100.0
Total	2,909	100.0		$ 489,044	100.0	

Treasury Department, Division of Tax Research

Source: Supplement to Statistics of Income for 1943, Part 2.

* Less than .05 percent.

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